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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1628

NOVELART MANUFACTURING COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Novelart Manufacturing Company, the Petitioner herein, prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above entitled case on November 27, 1970; Petition for Rehearing denied January 25, 1971.

OPINIONS BELOW

The Opinion of the Circuit Court of Appeals for the Sixth Circuit is reported in 434 F.2d 1011 and 26 AFTR2d 70-5837 and is printed in Appendix A hereto, infra, Page A1. The Memorandum, Findings of Fact, and Opinion of the Tax Court of the United States are reported in 52 T.C. No. 83 and are printed in Appendix A hereto, infra, Page A4.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 27, 1970. Rehearing was denied on January 25, 1971. The jurisdiction of the Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

(1) Where a corporation has a need for additional plant space to carry out the existing business, and the Board of Directors instructs its President to obtain cost estimates in order that a decision could be made as to whether a new plant should be built or an existing plant expanded; where the evidence shows that approximately six months after the close of the year ended June 30, 1961, the corporation acquired a plant costing $532,000.00; and where the Tax Court finds and concludes that at the end of the taxable year ended June 30, 1961, one of the reasonably anticipated needs of the business was additional plant space to cost approximately $532,000.00, and this was also the situation at the end of the taxable year ended June 30, 1962; is it not clear error on the part of the Tax Court to hold that with a need for $532,000.00 it was an unreasonable accumulation to fail to distribute at the year ended June 30, 1961, the amount of $39,034.73 and at the year

ended June 30, 1962, the amount of $44,116.98 and at the year ended June 30, 1963, the amount of $22,444.41?

(2) Where the Tax Court finds that the Petitioner had reasonable needs, including anticipated needs in the amount of $782,000.00, during the taxable years involved herein, but that at the beginning of the taxable years Petitioner had accumulated earnings of approximately 5 million dollars, of which approximately 2-1/2 million dollars was in cash and securities, (a) may the Tax Court find that the retained earnings in the three taxable years, for a total of $106,000.00, are subject to the penalty because they were not distributed? (b) may interest be imposed on such penalty? and (c) is not such a finding by the Tax Court really the imposition of the tax on accumulations in prior years barred by the Statute of Limitations?

(3) Where the Petitioner, in a three-year period, retained earnings of $106,000.00 and paid on a group insurance plan on its employees a premium of $68,000.00, should such premium be allowed before a penalty is imposed for unreasonable accumulation?

(4) Where a corporation in a three-year period has income subject to accumulated earnings tax amounting to $106,000.00, and during said period expends $782,000.00 for plant improvements, is it not in violation of Amendment XVI to the United States Constitution to impose the accumulated earnings tax on the undistributed $106,000.00 because from prior years' accumulations the corporation had surplus funds of $782,000.00, and thus you could not consider the $106,000.00 as part of the $782,000.00 actually expended?

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED

U. S. Constitution, Sixteenth Amendment

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration.

I. R. C., §264(a)(1)

(a) General Rule.— No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

I. R. C., §531

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

I. R. C.. §532(b)(1)

(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542).

I. R. C., §533(b)

(b) Holding or Investment Company.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

I. R. C., §534(a), (b), (c)

(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a) the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e) (2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notifica-

tion described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

I. R. C., §535

(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) Adjustments to Taxable Income.—For purposes of subsection (a) taxable income shall be adjusted as follows:

(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) Charitable contributions.—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) Special deductions disallowed.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) Net operating loss.—The net operating loss deduction provided in section 172 shall not be allowed.

(5) Capital losses.—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) Long-term capital gains.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryback or carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryback and carryover provided in section 1212).

(7) Capital loss.—No allowance shall be made for the capital loss carryback or carryover provided in section 1212.

(8) Bank affiliates.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(9) Distributions of divested stock.—There shall be allowed as a deduction the amount of any dividend

distribution received of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

(10) Special adjustment on disposition of antitrust stock received as a dividend.—If—

(A) a corporation received antitrust stock (as defined in section 301(f)) in a distribution to which section 301 applied,

(B) the amount of the distribution determined under section 301 (f) (2) exceeded the basis of the stock determined under section 301 (f) (3), and

(C) paragraph (9) did not apply in respect of such distribution,

then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

(c) Accumulated Earnings Credit.—

(1) General rule.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) Holding and investment companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated earnings and profits.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563(a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

I. R. C., §6501(a)

(a) General Rule.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

I. R. C., §6601(f)(3)

(f) Applicable Rules.—Except as otherwise provided in this title—

* * *

(3) Interest on penalties, additional amounts, or additions to the tax.—Interest shall be imposed under subsection (a) in respect of any assessable penalty, additional amount, or addition to the tax only if such assessable penalty, additional amount, or addition to the tax is not paid within 10 days from the date of notice and demand therefor, and in such case interest shall be imposed only for the period from the date of the notice and demand to the date of payment.

STATEMENT OF THE CASE

Petitioner was formed in Ohio in 1905 under the name of Progress Lithographing Company. For a period of fifty-five years petitioner carried on the business of a general lithographing enterprise conducted in various plants, including one in Amberley Village, Ohio, and one in Lebanon, Ohio.

In 1958 petitioner involved itself in a plan of research and development in connection with applying lithography to the corrugated box business. This was done with the purpose in mind of developing a new industry. Other competing and non-competing companies that engaged in the same process and development expended millions of dollars in pursuance of such plan.

As of January 1, 1960, the corporate business was rearranged by forming a subsidiary under its own name of Progress Lithographing Company in Ohio and changing its name to Novelart Manufacturing Company through a merger with and resulting in a Delaware corporation.

The obvious plan was twofold in that it would permit employee participation in the Progress plant through setting aside part of the Common and Preferred Stock for the employees' pension plan and, second, to permit the petitioner, primarily through its President, Mr. Charles H.

Klein, to devote its monies and Mr. Klein's energy and ability towards the pursuance of the research and development in the corrugated box field in order to produce business for this plant as well as the searching out and acquisition of other plants.

In Petitioner's Statement of grounds on which it relied to establish that earnings and profits had not been accumulated beyond the reasonable needs of the business, it was set forth, and these things were sustained by the testimony of the witness Klein, that in 1958 a test was conducted on behalf of petitioner to obtain reactions from manufacturers, advertising agencies, and design specialists to a new lithographed, corrugated, cardboard container which petitioner had designed. Petitioner was advised by the report from A. C. Nielsen Company that the results of such test indicated that petitioner's process known as "Pre-Lith" for preprinting corrugated, cardboard boxes had received very high praise from all respondents and indicated a clear commercial acceptance for such products. Petitioner pursued its research and development, obtained national recognition in trade publications, and in the process met with some experiences which required a complete change of the methods and approaches. The record indicated that after the changes were made, patents were applied for, but that under the changed conditions the business produced was substantial.

The new methods and developments were put into use; and when petitioner became satisfied of their commercial acceptance, on May 20, 1963, which is during the last of the three years involved herein, Application No. 281600 was filed with the United States Patent Office for a patent on "Lithographed-Corrugated". Patent No. 3,306,805 was granted by the Patent Office on February 28, 1967. Applications for additional patents were ap-

plied for and are still pending. Applications were made in a number of foreign countries, and some have been granted.

The patent issued covers "apparatus for making printed corrugated paper board" and is described as relating to printed corrugated paper board; and more particularly the invention is directed to apparatus for manufacturing corrugated paper board in which one facing sheet is formed from a plurality of separate printed sheets.

Petitioner's testimony of its President, Charles H. Klein, indicated that the witness had engaged for forty years in the business of lithography, paper products, and the converting of paper. Petitioner's business, in the operation of its plants until January 1, 1960, consisted of commercial lithography, production of labels, advertising materials, and any other printing on paper by lithography.

In 1958 Mr. Klein decided on developing the corrugated box and container business, and the owner of a substantial number of shares of stock, Mr. Miller, disagreed with the plan, resulting in Mr. Klein purchasing his stock and becoming the sole owner.

The development of the business is fully explained by Mr. Klein.

The testimony established that petitioner is still directly engaged in business in that it has continued the development of the new processes for obtaining business, and the manufacturing was being done by Progress Lithographing Company. The record establishes that the petitioner acquired a plant and machinery with the object in mind of manufacturing part of the process and permitting Progress to do part of it. During the years in question, Mr. Klein was an officer of petitioner, but held no office in Progress Lithographing Company. The pe-

titioner, during the taxable years, in addition to research and development, was the owner of plants, including production machinery. Some of this machinery went into the Mitchell Avenue plant. The plant is operated by Litho Carton & Container.

The witness further testified that petitioner recently acquired a plant in North Vernon, Indiana, which is operated directly by petitioner. This plant represents an investment of over $700,000.00 and with work in process it is expected to run to $1,500,000.00.

By agreement of the parties and with approval of the Court the exhibits attached to the Statement, which had been filed with the Petition in this case, were to be taken as "what they purport to be".

The witness testified that beginning with the purchase of the Mitchell Avenue plant in 1960, and thereafter, he actively sought out other acquisitions and businesses and started in a new venture to produce a machine for office use involving the shredding of paper and spent some $50,000.00 on that venture. To start the business, it required between $200,000.00 and $300,000.00. This venture continued from 1960 through 1962; and because of the lack of patents protecting the business, it was terminated.

The witness testified that he negotiated with U. O. Colson Company; the required purchase price was $1,500,000.00; and after negotiations for some time, these were dropped. These matters were all carried on on behalf of petitioner, Novelart. It acquired an interest in J. J. Hackett Company in Detroit, Michigan.

During the period, Novelart negotiated for the purchase of Manz Corporation in Chicago, Illinois, and Ar-

tistic Card Publishing Company of Elmira, New York. During said period, negotiations were conducted with R. C. Can Company and involved research, development, and production of a plastic lid. This resulted in an unsuccessful operation and was terminated. Petitioner sought to acquire an interest in Crystal Tissue Company in Middletown, Ohio, and had purchased some shares and had made an offer on a substantial number of shares, but one of the insiders in the company had outbid petitioner. Petitioner acquired 10% of the stock of APS, which was a paper specialty company, and, as a result thereof, obtained substantial business for its subsidiaries. Petitioner made an investment of $72,000.00 in Magna and, as a result, received business for its subsidiaries. It acquired the Rapid-American Building, which was occupied by the Rapid Electrotype Company. The building was occupied in part by two other firms engaged in graphic arts, one in rotogravure and another company in an allied business. Petitioner paid $275,000.00 for the building, and after a period of time it was decided to dispose of it rather than put it to use.

The President of petitioner testified that:

> "To have carried out the acquisition of one or two or three, and the one transaction that I have already discussed, and to have gone ahead with the potential and expansion of the corrugated business would have required a total of about 5 million dollars."

Respondent asserted that Petitioner is subject to tax on an unreasonable accumulation of income for the years and in the amounts as follows:

COMPUTATION OF ACCUMULATED TAXABLE INCOME

Year Ended	6-30-61	6-30-62	6-30-63
Corrected Taxable Income	$74,914.41	$313,756.69	$68,357.66
Divs. Rec'd. Credit	15,658.06	16,924.24	8,910.38
Sub-totals (a)	$90,572.47	$330,680.93	$77,268.04
Less:			
Income Tax	$33,054.60	$ 93,790.43	$19,725.80
Excess Contributions	1,969.53	—	981.41
Capital Gains less Attributable tax	1,113.61	177,373.52	18,716.42
Sub-totals (b)	$36,137.74	$271,163.95	$38,973.63
Balance (a) – (b)	$54,434.73	$ 59,516.93	$38,294.41
Less:			
Dividends Paid	15,400.00	15,400.00	15,400.00
Accumulated Taxable Income	$39,034.73	$ 44,116.98	$22,894.41
Tax @ 27½%	$10,734.55	$ 12,132.17	$ 6,295.96

REASONS FOR GRANTING THIS WRIT

I. Petitioner Was an Operating Company and Not a "Mere Holding Company"; and Where Petitioner Spent More Than Its Net Earnings in the Taxable Years for the Purpose of Plant and Equipment, It Did Not Unreasonably Accumulate Earnings.

The evidence in this case, as developed during the trial, clearly established the fact that petitioner was actively engaged in business, in research and development and investment, the search for diversification, and the acquisition of additional plants even though the production was carried on through subsidiaries. This certainly was not a mere holding company. We believe that the business carried on by the petitioner was substantially of the same nature as that of *Crawford County Printing and Publishing Co.* where the Tax Court in 17 T.C. 1404 concluded:

> "HELD: That petitioner did not accumulate its surplus or profits beyond the reasonable needs of its

business and, accordingly, is not liable for additional surtax under section 102, I. R. C."

In the Opinion of the Court at Page 1413, it is stated:

> "There is no contention, and none could fairly be made, that petitioner was organized for the purpose proscribed by section 102, I. R. C. *Nor was petitioner a mere holding company.* It was an operating company actually engaged in the newspaper business."

At Page 1414, the Court stated:

> "Determination of the reasonable needs of its business is, in the first place, a task for the officers and directors of the corporation. What is reasonable in one situation may be unreasonable in a different context of facts. We should be hesitant to attribute a sinister or ulterior motive to the corporation unless such a factual situation clearly appears. The law contemplates that any legitimate business may grow if legitimate means be employed. There are various and sundry ways, all natively legitimate, by which a business may acquire the means of growth and finance its proper expansion. It can issue capital stock or other securities. It may resort to bank loans. Yet again, it may plow its earnings back into the business for immediate uses. *Still another method, equally legitimate, absent an ulterior purpose, is to accumulate its earnings until the expansion can be timely undertaken.*"

We further direct the Court's attention to *Apollo Industries, Inc.* v. *Commissioner,* 358 F.2d 867, where the Court stated:

> "2. In assessing reasonably anticipated business needs to determine liability for accumulated earnings tax, court should keep in mind that such needs vary and are dependent upon nature of business, its credit policies, amounts of inventories and rate of turnover, amount of accounts receivable and collec-

tion rate thereof, availability of credit to business, and similar relevant factors. 26 U.S.C.A. (I.R.C. 1954) §§ 531, 532, 533."

"3. In review of assessment of accumulated earnings tax, neither summary view of balance sheet nor of working capital, nor of amount of net liquid assets can give court sufficient appreciation of real needs of business for funds to assess its reasonably anticipated business needs. 26 U.S.C.A. (I.R.C. 1954) §§ 531, 532, 533."

In the case tried by Judge Atkins, 47 T. C. 75, affirmed, *Rhombar Co.* v. *Commissioner*, 386 F.2d 510, the Court stated:

"4. Failure of Tax Court to consider allegations of taxpayer's statutory statement in support of its claim that it had not accumulated its earnings beyond its reasonable business needs in determining whether taxpayer was a mere holding or investment company within statute making such a fact prima facie evidence of tax avoidance purpose with respect to shareholders was not error where taxpayer never sought to place the statement in evidence or to establish any of the facts contained therein by competent testimony, notwithstanding that Commissioner had made no effort to controvert allegations of statement even though he had been in possession of statement for 18 months before trial. 26 U.S.C.A. (I.R.C. 1954), §§ 533(b), 534, 535(c)(1); Tax Court Rules, rule 31(f), 26 U.S.C.A. (I.R.C. 1954) § 7453."

Attention is called to the record in this case where the Stipulation, in Paragraph 3, admits that a true and accurate copy of petitioner's Statement was attached to respondent's Answer and marked Exhibit D; and in the trial of the case the Court admitted the exhibits attached to the Statement for whatever they purported to set forth, and the testimony of the witness Klein reviewed in detail the activities of the petitioner in its efforts to make

acquisitions as well as the actual investments in customers and the purchase of plants; so that the present case meets the objection set forth in the above cited Decision.

The record further establishes that after the years in question petitioner had actually acquired and was operating the North Vernon, Indiana plant with the expenditure of a substantial amount for the purchase of plant and equipment and the needed operating capital. While objection was made to such testimony, this was overruled by the Court and is in line with the Tax Court's recent Decision in *Faber Cement Block Co.*, 50 T. C. No. 31. In this late case the Tax Court pointed out that the "specific definite, and feasible" requirement of the Regulations does not call for "formal blueprints for action". The test is whether expansion is a real consideration during the years involved. A big factor is whether the taxpayer actually goes ahead with its expansion program. The record in this case clearly establishes the expenditure of some $850,000.00 during the taxable years as well as the expenditure and requirement of a total of a substantially higher amount in the years following the taxable years, but before the trial of this case.

A complete need for diversification, as shown by the testimony presented, should persuade the Court to conclude that the earnings were accumulated for the reasonable needs of the business. Petitioner's research and development of new products for its business as well as the business of its subsidiaries and its active efforts to locate a new business justified large accumulations, even though throughout the period petitioner had not selected a particular business, but considered many alternatives. *Alma Piston Co.*, 22 T. C. M. 948, 1963 P-H T. C. Memo ¶ 63,195.

We respectfully direct the Court's attention to the Decision by the Fifth Circuit in *Mead's Bakery, Inc.* v. *C.I.R.*, 364 F.2d 101:

> "5. Amounts advanced by bakery company to its subsidiary did not represent an unreasonable accumulation of earnings and bakery company, during years in issue, was not availed of for purpose of avoiding income tax with respect to its shareholders, where bakery company's plans for expansion and improvement were not only specific but the company had initiated several of proposed uses of the funds and was in process of further initiating others. 26 U.S.C.A. (I.R.C. 1954) §§ 531-537."

We believe that the Court's statement in *Shaw-Walker Co.* v. *C.I.R.*, 390 F.2d 205, is very applicable to the present case:

> "6. Fact that a taxpayer has financed its growth from retained earnings rather than from sale of additional stock or commercial borrowing should not place it in a position of being subjected to a penalty tax under provision of Internal Revenue Code relating to imposition of accumulated earnings tax. 26 U.S.C.A. (I.R.C. 1954) § 531."

The evidence in this case disclosed that the petitioner had actually spent on the purchase of the Mitchell Avenue plant, the investment in Magna, the investment in APS Company, and the investment in Crystal Tissue a total amount in excess of One Million Dollars; that the acquisition and operation of the North Vernon, Indiana plant involved an investment and capital requirement of One Million Dollars; that the acquisition of the plants looked at and negotiated for by the petitioner would have required an investment of up to Five Million Dollars. These plants or any part of them would have required all of the monies accumulated by petitioner in over fifty

years. The total cash, accounts receivable, and inventories during the taxable years, available to the petitioner, would have been insufficient to meet its program of diversification and expansion.

During the taxable year ended June 30, 1961, its current assets were reduced by some $650,000.00. By the end of the taxable year June 30, 1963, the current assets had been decreased by $850,000.00. The actual earnings of the corporation available for distribution during this three year period was $103,000.00; and if credit is given for the insurance premium paid on its key men, the available funds in the total of the three taxable years would have been approximately $37,000.00, hardly a good example of unreasonable accumulations of earnings.

We direct your attention to the following cases:

Electric Regulator Corporation v. *C.I.R.*, 336 F.2d 339:

> "1. Use to which a corporate taxpayer put its previously accumulated earnings, as well as its anticipated needs, is an essential consideration in determining whether, for undistributed earnings tax purposes, earnings and profits have been accumulated beyond reasonable needs of the corporation. 26 U.S. C.A. (I.R.C. 1954) § 537."

Mohawk Paper Mills, Inc. v. *U. S.*, 18 AFTR2d 6111:

> "Accumulated earnings tax not imposed: corporation made reasonable accumulations for needs of its business. Corporation contemplated building a new paper machine. Corporation needn't have borrowed. Accumulations weren't motivated by tax avoidance. Reference: 1966 P-H Fed. ¶ 4056."

In the above-quoted *Electric Regulator Corporation* case, at Pages 345 and 346 the Court stated:

> "Courts * * * must not blind themselves to the realities in this age of rapid technological change.

> The product of today is frequently outmoded tomorrow. * * * Nor is it always possible for a company in advance to set aside a specific sum to achieve a specific goal. Comments made in the past to the effect that a definite plan actually followed through must be on the company's books and records before moneys assigned thereto become anticipated needs may have to be appropriately qualified in particular cases.
>
> "I the Tax Court's views here were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth as it—not the corporate directors—decided how each company should handle its corporate and financial affairs * * *."

The Supreme Court has put to rest any question as to "the purpose" necessary to make § 531 applicable. *United States* v. *Donruss Co.*, 393 U.S. 297 (1969). In *Donruss*, the trial court instructed that, in § 531 cases, tax avoidance had to be "the purpose" of the accumulations. Reversing the trial judge, the Sixth Circuit held the tax applied if tax avoidance was the "dominant, controlling or impelling motive" for the accumulation. The Supreme Court, in a 6-3 decision, disagreed with both the trial and appellate courts. Accordingly, pursuant to *Donruss*, the taxpayer, having failed tc prove the reasonable business needs for the accumulation, must establish that tax avoidance was not "one of the purposes" for the accumulation of earnings.

In *C.I.R.* v. *The Shaw-Walker Co.*, 393 U.S. 478 (1969), the Supreme Court vacated judgment and remanded the Sixth Circuit's decision *per curiam* for reconsideration in the light of the *Donruss* decision. In *Battlestein Investment Co.* v. *United States*, 69-1 USTC ¶ 9219, 23 AFTR 2d 69-784 (S.D. Tex. 1969), the *Donruss* "purpose" test was cited. The court emphasized loans to shareholders, investments in unrelated assets and the declaration of dividends for the sole purpose of avoiding personal holding company

treatment under the 1964 revision to conclude that avoidance of the stockholders' tax was one of the purposes for the accumulation.

Calling attention to § 537's provision that "the term 'reasonable needs of the business' includes the reasonably anticipated needs of the business," the Tax Court in *Adolph Coors Co.*, T. C. Memo 1968-256, found no unreasonable accumulation of earnings where they were retained: (1) to assure completion of projects begun during the taxable years; (2) to protect against anticipated increases in inventories packaging and other increased production and administration costs; (3) to self-insure against a fourteen million dollar damage suit; (4) *to fund experiments in new modes of manufacturing.*

The Tax Court in *Faber Cement Block Co.*, 50 T. C. 31 (1968), *acq.* 1968-43 I.R.B. 6, has expanded on its opinions in *Nemours Corporation*, 38 T. C. 585 (1962) *aff'd per curiam* 325 F.2d 559 (3rd Cir. 1963) and *Whitney Chain & Mfg. Co.*, 3 T. C. 1109 (1944), *aff'd per curiam* 149 F.2d 936 (2nd Cir. 1945). In *Faber Cement* the Commissioner argued that, without disturbing liquid assets, a corporation has other assets for utilization as dividends in kind; therefore, the corporation, having failed to so distribute in kind, had unreasonably accumulated earnings. Labelling the Commissioner's view distorted, the Tax Court noted that, in *Nemours* and *Whitney Chain & Mfg. Co.*, it first determined that the accumulated earnings were not needed for the reasonable needs of the business and *then* searched for potential sources of dividends. *Faber Cement* also demonstrates that ultimate fruition of corporate plans, even though in years not before the Court, greatly assists the taxpayer. *Cf. Dixie Inc.* v. *C.I.R.*, 277 F.2d 526 (2nd Cir. 1960).

Giving weight to a variety of elements, the Sixth Circuit reversed the unreasonable accumulation holding in

The Dahlem Foundation, Inc. v. *United States,* 69-1 USTC ¶ 9129, 22 AFTR2d 5962 (6th Cir. 1968). The court noted that, if all the earnings and profits had been paid out, the corporation would have possessed inadequate reserves to purchase land it planned to acquire and to meet contingencies. The court was not disturbed because one of the major land purchases took place in a subsequent tax year.

II. (A) Earnings of Petitioner Were Determined to Be Necessary for Financing Its Established Plans for Expansion.

What we have said above applies with equal force under this subheading. The point that we wish to stress is that the earnings of the petitioner, subject to unreasonable accumulation, are the earnings of the taxable years involved, and not the accumulation over a period of some fifty years before. It certainly is clear and obvious that the earnings during the years in question, amounting to either a little over $100,000.00 or, if the insurance premium is deducted, to a little over $35,000.00, was hardly sufficient to meet any one of the expenditures made during the taxable years.

Certainly, *the law does not undertake to penalize undistributed earnings, except such as are earned during the taxable years under consideration.* The law clearly does not authorize the Commissioner or permit the Courts to impose a penalty tax measured against all undistributed earnings in the years in question simply because there had been earnings accumulated in prior years. This is not to say that the prior years' earnings may or may not be given consideration in helping the Court determine whether the current years' earnings have been reasonably accumulated. However, it would be unreasonable to require that a taxpayer first distribute *all* of its accumulations before it can retain a penny of the current years' earnings.

Petitioner's plans for expansion were evidenced by the Minutes of the corporation, which were offered during the trial and had been submitted with petitioner's Statement which was attached as an exhibit to respondent's Answer. Whether such plans were at great length or absolutely specific on the subject is not required in a case where a corporation has only one stockholder as is the stipulated facts in this case. We think that this Court should consider in connection therewith the language of the Court in a recent case.

> "We realize that petitioner's directors act in a rather informal manner and that their plans for expansion might not be as specific as desired nor are all their plans reduced to writing and contained in formal minutes. However, the history of petitioner has been to act in an informal manner. The executive committee, which is the core of the petitioner's management, meets daily and when necessary can act with deliberate speed. A closely held corporation cannot be held to the same strict formalities of large public corporations. * * * *Duke Laboratories, Inc.* v. *United States* * * * 337 F.2d 280 (C.A. 2, 1964). We have found as a fact that petitioner did not have any formal plans for expansion after 1958. However, by this finding we do not mean that petitioner would not be justified in retaining part of its earnings for future expansion. Nor do we mean by this finding that petitioner did not have any plans for expansion subsequent to 1958. As stated earlier, petitioner's entire history reflects a policy of constant growth. It is not always possible for a company in advance to set aside a specific sum to achieve a specific goal." *John P. Scripps Newspapers,* 44 T.C. at 469.

This is simply a more generalized statement of the things which the Second Circuit said about the funding of new product development in *Electric Regulator Corporation* v. *Commissioner,* 336 F.2d 339 (2d Cir. 1964).

Both the Second Circuit and the Tax Court in other recent cases have construed the Statute and Regulations in the same way the Tax Court did in the *Scripps* case. *Duke Laboratories, Inc.* v. *United States,* 337 F.2d 280 (2d Cir. 1964); *Ted Bates & Co.,* 24 CCH TCM 1346 (1965).

(B) Interest Should Not Have Been Imposed.

It should be noted that this Court in *United States* v. *Donruss,* supra, observed that the accumulated earnings tax was intended by Congress to be a penalty and *not* a tax. See also, *Montgomery Co.,* 54 T.C. 986, at 1010. § 6601 of the Internal Revenue Code clearly establishes that interest is allowed and computed on tax. However, Paragraph (f)(3) of § 6601 establishes with equal clarity that no interest is to be imposed in respect of any penalty until ten days from the date of notice and demand therefor.

The exact question was before the Court of Claims in *Motor Fuel Carriers, Inc.* v. *U. S.,* 420 F.2d 702 (1970), in a suit to recover the amount paid as interest upon accumulated earnings tax. The court, in an opinion by Judge Davis, held that it was unnecessary to find that the accumulated earnings tax was a "penalty", since in its view it was an "additional amount" or "addition to the tax" within the meaning of Section 6601.

In an extremely perceptive analysis of the legislative history of the accumulated earnings tax and of the interest section, Judge Davis concluded that the intention of Congress was clear that, for the purposes of the imposition of interest, Section 531 imposes an "addition to the tax" upon which interest begins to run only after demand. He stated at page 705 of the Opinion:

> ". . . that the tax is not 'self-assessing' but is levied only after and by determination of the Revenue Service. There is no provision in, or part of, Treasury

Form 1120 (the return form) for reporting the amount subject to this tax; nor are there any schedules or instructions for reporting the item. It is left wholly to the Government's initiative. See Mertens, Law of Federal Income Taxation, Volume 7, Section 39.57 (Revised Edition 1967).

"This procedure has not come about by happenstance, the Treasury's neglect or the irresponsibility of corporate taxpayers. It is inherent in the nature of the tax—and was formerly recognized specifically by Congress—that a taxpayer can hardly determine for itself, with any accuracy, if the tax is due, and if so, to what extent."

(C) The Statute of Limitations.

§ 6501 of the Internal Revenue Code bars the imposition of an assessment after the lapse of three years. The net effect of the Decision of the lower Courts in this case is to permit the imposition of a tax on earnings accumulated for years prior to July 1, 1960, being years against which the Statute of Limitations had run. As we have pointed out, it was in the prior years in which Petitioner had accumulated the earnings upon which the assessment was based in the years in question. This may best be illustrated by noting the decline in cash and liquid assets during the fiscal year 1961:

Cash as 7/1/60	$1,558,234.34	
Governments and stocks, etc.	1,478,139.85	$3,036,374.19
Cash at 6/30/61	$1,948,241.20	
Stocks, etc. (no governments)	682,356.75	2,630,597.95
Decline in such liquid assets		$ 405,776.24

Petitioner was entitled to a credit equal in amount to the earnings and profits for prior years which had been

retained for the reasonable needs of the business, which credit was in the full amount of the retained earnings for such prior years. It is obvious, therefore, that the accumulated taxable income for the years in question, subject to the imposition of the § 531 tax, amounted to zero.

III. The Amount Expended for the Premium Paid for Life Insurance on Key Employees Should Be Deducted from Net Earnings Before Considering Earnings Available for Distribution.

The Tax Court decided in *General Smelting Co.*, 4 T. C. 313, at Page 324, as follows:

> "The payments of the premiums on these policies in the years 1939 and 1940 and the payments of the loans and interest which stood against them increased the cash surrender value thereof, stopped the 6 percent interest running against the loans to the extent they were paid, and increased petitioner's equity in the policies.
>
> "Under the circumstances which we have just narrated, we think that petitioner's expenditures in connection with these policies in 1939 and 1940 were related to its business, to wit, the preservation and conservation of its funds, and not a mere investment of its funds in an outside venture or an investment unrelated to its business. On issue 2 we sustain petitioner."

In the case of *Emeloid Co.* v. *Commissioner of Internal Revenue*, 189 F.2d 230, the Court stated at Page 233, as follows:

> "What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets—managerial skill and

experience. In fact, the government has not seriously contended here that key man insurance is not a proper corporate purpose."

The difficulty in this case arises from the fact that the respondent seems to rely entirely on Section 533(b) which states:

> "The fact that any corporation is *a mere holding or investment company* shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders."

Our first question then is: What is meant by the language, "a mere holding or investment company"? It certainly does not mean a "personal holding company" because such a company is excluded or exempted or excepted from the accumulated earnings tax under Section 532(1). The word "*mere*" in its common, ordinary acceptance is certainly well defined by Webster's Dictionary, and Congress should be taken to have meant its ordinary meaning. Webster defines "mere":

> "Nothing less than—absolute, sheer, unqualified—only this and nothing else, nothing more than."

In line with such definition, how can respondent argue that since petitioner, in addition to investment, engaged in research and development, that it was a mere investment or holding company? The Tax Court did not decide this issue.

In Prentice-Hall, Paragraph 21,332, it is set forth:

> "*The tax is imposed only on excessive accumulations in the current year.* Excessive accumulations in prior years are not taxed in the current year, although prior accumulations may be a factor in deciding if the current accumulation is excessive."

Under the provisions of law, you not only exempt from the imposition of tax accumulations in prior years, but you also exclude from consideration various items listed in the act, particularly capital gains, dividends paid, and distributions made.

The respondent makes no claim of any tax due for the approximately Five Million Dollars of earnings accumulated prior to July 1, 1960, nor does he take into consideration the dividends and distributions made prior to that date nor in the three succeeding taxable years, but disregards the fact that there had been a distribution of premiums paid on policies of insurance owned by the corporation-taxpayer during the three taxable years.

No issue was made of this matter by the assessment for the taxable years in question nor for more than ten years previously. The company purchased policies of life insurance on its key personnel and paid the premium in each of the years. The premium was not deductible. ¶ 16,751, Prentice-Hall, states:

> "Basic Rules—In general, deduction is not allowed for the payment of life insurance premiums. Correspondingly, with certain exceptions, the proceeds of a life insurance policy paid by reason of the death of the insured are exempt from income tax. See ¶ 8,111, et seq."

The above paragraph merely paraphrases the language of Section 264 of the Internal Revenue Code, which states that no deduction shall be allowed for premium paid on a life insurance policy covering the life of any officer or employee * * *. There is no question in this record but that the policies were purchased and are owned by the petitioner. Here, we direct the Court's attention to Exhibits 1, 2 and 3, the Tax Returns of the Petitioner for the taxable years, where the cash value of the life insurance is

carried in Schedule L, Line 12. You will notice that as of the end of the taxable year the cash surrender value of the insurance was $252,566.58; and this Court will certainly know it to be a fact, a fact of which judicial knowledge may be taken, that with the payment of premiums of an average of $22,000.00 a year that it would take ten or more years to build a cash surrender value of the amount above-mentioned.

We do not believe the Court will pay much attention to respondent's argument that because Mr. Klein owns 100% of the stock of the petitioner, and that because of such control he might, at some future date, cause a change to be made by the petitioner of the designated beneficiaries or, perhaps, dispose of its ownership that, for that reason, the payment of premium by the petitioner should not be considered as a distribution rather than an accumulation of income. The fact is, and respondent's counsel and the Court know, that if Mr. Klein caused a distribution to be made, which he has a perfect right to do, he would pay tax on the amount distributed.

When we look to Exhibit 7 attached to the Stipulation, we find that the key personnel of petitioner covered under these policies of insurance are A. C. Sides, H. J. Bruder, Charles H. Klein, Lucien Lazarus, Herb Fritz, and Marvin H. Schwartz. No question was raised by the respondent that these people are not key personnel of the petitioner, nor that the insurance carried on their lives was improper, nor that the payment of premium on the policies insuring the lives of any of them, or primarily Charles H. Klein, constituted a distribution to any of the persons.

In ¶ 16,765, Prentice-Hall, the rule is stated:

> "Premiums paid by an employer on life insurance covering the life of an officer or employee are not de-

ductible *if the employer is a direct or indirect beneficiary under the policy.*

"If an employer insures the life of an officer or employee and is not a direct or indirect beneficiary under the policy, the premiums paid by the employer are deductible as additional compensation, provided the total compensation so paid is reasonable for the personal services that are actually rendered. Such deduction will not be disallowed merely because the employer derives a benefit from the increased efficiency of the officer or employee.'

The Tax Court has affirmed the holding that a deduction is allowed to the corporation for insurance premiums paid on the lives of officers where the corporation was not the beneficiary, and the total compensation was found to be reasonable. *Brown Agency, Inc.*, 21 BTA 1111; *Berizzi Brothers Co.*, 16 BTA 1307; *Peerless Pacific Co.*, 10 BTA 103.

The Court has sustained the Commissioner in disallowing deduction for payments by an employer-corporation on insurance on officers or employees (usually the principal officers and stockholders) where the employer is directly or indirectly a beneficiary. *Peerless Patterns Co.*, 29 BTA 690; *Chism Ice Cream Co.*, 322 F.2d 956; *Wilcox Investment Co.*, 3 T. C. 458.

It must be obvious that the premium on the life insurance was proper; *was paid out; was no longer available for distribution;* did not constitute an accumulation; and should have been considered in determining the remaining earnings during the taxable years available for distribution.

The Sixth Circuit stated:

"The short answer to the contention that a deduction should be allowed for life insurance premiums is that 26 U.S.C. § 535(b) provides for specific adjust-

ments in computing the accumulated taxable income. That section does not authorize an adjustment in the form of a deduction for life insurance premiums."

That Court as well as the Tax Court is confusing the language of § 535(b) relating to adjustments with the provisions of § 535(c), which permits the application of earnings for the reasonable needs of the business. Money expended by the taxpayer for plants as an investment was properly permitted to be credited as an expenditure for the reasonable needs of the business. The Tax Court found that at June 30, 1961, there was a reasonably anticipated need of the business of $250,000.00. This was also the situation at June 30, 1962. The Court said:

> "The only reasonable needs including anticipated needs, shown as of that time amounted to $782,000. The same is true with respect to the taxable years ended June 30, 1962 and June 30, 1963."

Having in mind that the insurance on the key employees had existed from 1940, for a total of about 22 years, it is hardly right to come in at this late hour and say that such premium was not a reasonable need of the business.

IV. The Constitutional Question.

This case, for the first time, presents the question whether a corporation that over a period of sixty years had accumulated earnings is to be treated differently than a corporation that had no accumulations over the $100,000.00 credit provided by Section 531 of the Internal Revenue Code. To put it differently and having in mind that Federal taxes are based on an annual basis, can a corporation be held to have unreasonably accumulated any part of its current earnings because it had a large surplus accumulated in prior years? The Tax Court stated:

> "Here, the petitioner, as of the beginning of the taxable year ended June 30, 1961, had accumulated

earnings and profits from prior years in the amount of $4,772,080.74, of which $1,558,234.34 was represented by cash, and $1,478,139.85 was represented by investments in Government obligations and stocks, bonds and other securities. *It is against this background that we must consider whether the earnings and profits of the taxable year in question were permitted to accumulate beyond the reasonable needs of the business.*"

"* * *, in September, 1962, such plant was purchased by petitioner for $532,000.00. Under these circumstances, we think it reasonable to conclude that as of the end of the taxable year ended June 30, 1961, one of the reasonably anticipated needs of the business was additional plant space to cost approximately $532,000.00. This was also the situation at the end of the taxable year ended June 30, 1962."

In the present case the Commissioner determined accumulated taxable income for the years ended June 30, 1961, in the amount of $39,034.73, out of which amount the taxpayer had paid premiums on a group life policy on its officers in the amount of $24,857.05, and in the year ended June 30, 1962, the amount of $44,116.98, out of which the taxpayer had paid a premium in the amount of $22,212.35, and in the year ended June 30, 1963, income of $22,444.41 and premium paid in the amount of $21,495.40. Thus, the total income subject to accumulated earnings tax for the three year period was $106,000.00, and, during that three year period, it paid out premium on insurance the amount of $68,000.00.

Assuming, *arguendo,* that the payment of premium on life insurance, although a necessary expense, was not to be deducted from the accumulated earnings tax income during the three year period of $106,000.00, as against this amount the Tax Court found that the reasonable needs of the business during the three taxable years involved here-

in was the aforementioned amount of $532,000.00, and the Tax Court further finding that "there was a reasonably anticipated need of the business of petitioner of about $250,000.00 for this purpose".

The Tax Court having found a reasonable need for business of a total of $782,000.00, certainly the $106,000.00 was not sufficient to meet such needs.

We are then faced with this question: If a corporation has an accumulated surplus at the beginning of the year of $882,000.00, that is the specific exemption of $100,000.00 and the reasonable needs of $782,000.00, it would be taxed on the $106,000.00 of undistributed earnings during the three year period. If, on the other hand, the corporation has a surplus of, let us say, $650,000.00, the tax would not be applicable. Under such a situation where the existence or non-existence of this tax is based on what a corporation has accumulated in prior years, such a law cannot apply equally to all corporations, and it would seem to be in violation of the United States Constitution.

The Sixteenth Amendment to the United States Constitution provides:

> "The Congress shall have power to lay and collect taxes on *incomes*, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

In *Helvering* v. *Northwest Steel Rolling Mills*, 311 U.S. 46, the Supreme Court held that the fact that surtax under Revenue Act 1936, §§14, 26(c) (1), was imposed upon annual income only, if not distributed, did not make it anything other than a true tax on "income" rather than "capital" within the meaning of this amendment, irrespective of whether there might be an impairment of the capital

stock. The reasoning behind the Court's Opinion was that the tax was on undistributed income in its true sense and did not violate the Sixteenth Amendment to the Constitution. In the present case, the tax would not apply in that in the three year period the total income subject to tax was $106,000.00, and the reasonable needs during that period was $782,000.00, but the Tax Court held that the tax applies because the capital accumulated by the taxpayer in more than half a century before the tax year was sufficient to meet the $782,000.00, and, for that reason, it should have distributed the $106,000.00. This cleary is a tax reasoned and based on the prior accumulations, which constituted in law capital, rather than a tax on the income of the current tax years.

The Tax Court cites as authority for its position its earlier decision in *John P. Scripps Newspapers*, 44 T. C. 453, and *Smoot Sand & Gravel Corporation* v. *Commissioner*, 274 F.2d 495. A careful reading of the Opinions in those two cases clearly distinguishes them from the present case. This case clearly presents for the first time the question whether it was the intention of Congress, and within its power, to lay a different tax on corporations that were richer than others. It measured the difference by wealth or capital, and in doing so, we contend, it ran afoul of the Sixteenth Amendment to the United States Constitution. We contend that such a tax would also do violence to the provisions of the Fifth Amendment of the United States Constitution, which requires equal treatment and without discrimination among taxpayers.

The Supreme Court in considering the earlier accumulated earnings case, *Helvering* v. *National Grocery Co.*, 304 U.S. 284, sustained the constitutionality of the law insofar as it permitted the imposition of a penalty tax on the corporation formed or availed of for the purpose of avoid-

ing tax on its shareholder. Here, we are faced with the question whether or not a law which measures the tax or penalty by the wealth of the taxpayer can be sustained.

The United States Supreme Court in the case of *Healy and Smith v. Commissioner,* 345 U.S. 278, taught us the lesson that:

> "Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the account is made and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed."

The taxpayer in this case, over a period antedating the effective date of the income tax law, during years when income tax rates ranged in the 1% to 4% bracket, was able to build up a substantial business and accumulate a substantial surplus. Whether this surplus was made up of earnings, which are subject to the accumulated earnings tax, or were made up of capital gains or contributions to capital, which are not subject to tax, was not and could not be an issue in the trial of this case; yet, the Tax Court merely looks at the "wealth" of the petitioner and states that because it has total assets of 5 million dollars, and because half of that, or 2-1/2 million dollars, is in cash and securities, it is subject to the penalty even though its earnings during the taxable years were about $100,000.00, and its expenditures were about $800,000.00, and its current assets at the beginning of the tax period involved herein were $2,657,551.54 and at the end of the taxable years were $1,805,222.20 or clearly a reduction of about $850,000.00.

Petitioner's current assets as of June 30, 1960, June 30, 1961, June 30, 1962, and June 30, 1963, were as follows:

	6-30-60	6-30-61	6-30-62	6-30-63
Cash	$1,558,234.34	$1,948,241.20	$2,112,230.50	$1,768,253.27
Gov't Obligations	995,399.82	–0–	–0–	–0–
Notes and accounts receivable	103,917.38	47,071.98	98,308.36	26,625.52
Inventories	–0–	12,101.83	10,668.41	10,343.41
Total:	$2,657,551.54	$2,007,415.01	$2,221,207.27	$1,805,222.20

The Tax Court could not see how the payment of premiums on group policies could be given consideration in view of the fact that Congress did not make such premiums deductible. This is a tax based on accumulation, and no accumulation exists where there is a distribution of part of the earnings for insurance purposes. Just the same as where there is an investment of part of the earnings in plant equipment and machinery, such investment is not a deduction, but is given consideration in determining accumulated earnings tax.

This is not a case where the taxpayer failed to pay dividends because the record clearly established the following:

In each of the years involved substantial dividends were paid out of the taxpayer's current earnings after taxes, as the following information clearly reflects:

Year	Earnings after Taxes for Dividends	Dividends Paid	Percentage of Earnings Paid in Dividends
F/Y 1961	$49,434.73	$15,400.00	31.22%
F/Y 1962	$59,406.10	$15,400.00	25.9%
F/Y 1963	$37,372.71	$15,400.00	41.2%

It is interesting to note that during the presentation of this case to the Court below Counsel for Respondent was asked by the Court that if capital gains were not subject to the tax imposed by § 531, when did the change occur, subjecting them to tax. Counsel's answer was that the change occurred after the capital gains became part of surplus. There is no statutory authority for, nor do the Decisions support, this statement. Since § 535(b)(6) specifically exempts from the tax long-term capital gains in the year of receipt, it would seem anomalous to determine that such gains lose their exempt status in years subsequent to their receipt.

CONCLUSION

For the foregoing reasons this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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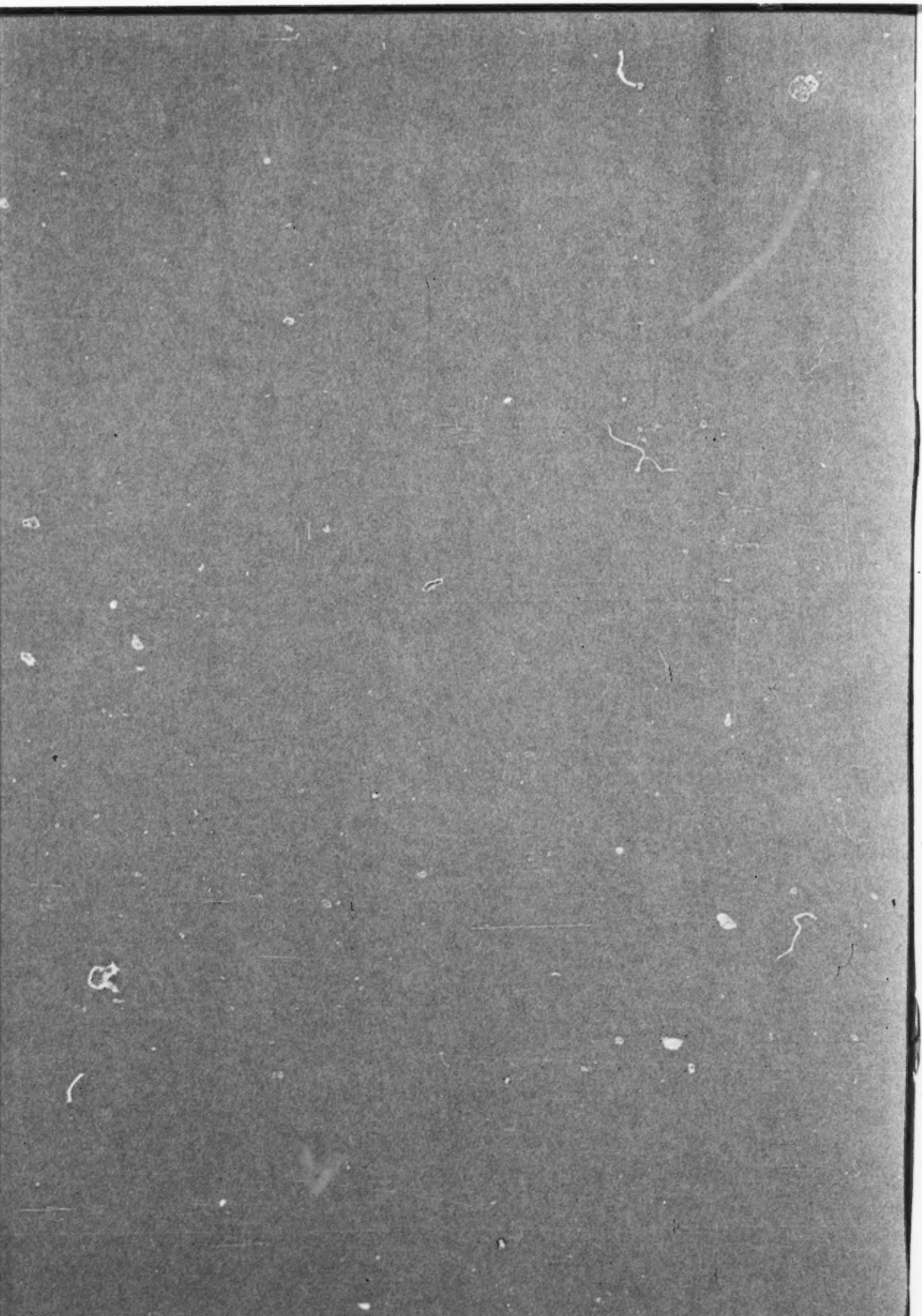

COURT OF APPEALS OPINION

No. 20251

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

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434 F.2d 1011, 26 AFTR 2d 70-5837

NOVELART MANUFACTURING COMPANY,
Petitioner-Appellant,
v.
COMMISSIONER OF INTERNAL REVENUE,
Rsepondent-Appellee.

APPEAL from the United States Tax Court.

Decided and Filed November 27, 1970.

Before PHILLIPS, Chief Judge, and WEICK and EDWARDS, Circuit Judges.

PHILLIPS, Chief Judge. The taxpayer appeals from the decision of the Tax Court finding deficiencies for the fiscal years ending June 30, 1961, 1962 and 1963, respectively, in accumulated earnings tax imposed by § 531, Internal Revenue Code of 1954, 26 U.S.C. § 531.[1]

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1. § *531. Imposition of accumulated earnings tax*

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

The Tax Court agreed with the Commissioner in holding that the taxpayer was availed of for the purpose of avoiding income taxes on Klein, the sole stockholder of taxpayer, by unreasonably accumulating earnings and profits. The ultimate finding of fact of the Tax Court was that during each of the taxable years in question the taxpayer permitted its earnings and profits to accumulate beyond the reasonable needs of its business.

The findings of fact and decision of the Tax Court are reported at 52 T.C. 794, to which reference may be had for a complete recitation of pertinent facts. We affirm.

The accumulated earnings tax is discussed in some detail in *U.S.* v. *Donruss Co.*, 393 U.S. 297, reversing 384 F.2d 292 (6th Cir.), and in *Shaw Walker Co.* v. *Commissioner*, 390 F.2d 205 (6th Cir.).[2]

The accumulated earnings tax is imposed on corporations which accumulate their earnings and profits beyond the reasonable needs of their business for the purpose of avoiding the income tax with respect to their shareholders. Where an accumulation beyond its reasonable business needs has been permitted, the taxpayer has the burden of proving, by the preponderance of the evidence, that avoidance of income tax on its shareholders was not one of the purposes of the accumulation. *U.S.* v. *Donruss Co., supra.*

Applying the guidelines set forth in *Donruss*, we find no error in the decision of the Tax Court in the present case. We hold that the findings of fact of the Tax Court are not clearly erroneous, Rule 52(a), Fed. R. Civ. P., but to the contrary are supported by substantial evidence.

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2. In *Shaw Walker* the Supreme Court granted certiorari and remanded the case to this Court for further consideration in the light of *Donruss*, 393 U.S. 478. This Court thereupon remanded the case to the Tax Court. 412 F.2d 858.

We affirm for the reasons set forth in the opinion of the Tax Court.

Only two questions require further discussion. The taxpayer contends that: (1) it is entitled to a deduction, in determining its accumulated earnings tax, for premiums paid on life insurance on the lives of its key men; (2) that the tax as imposed violates the Sixteenth Amendment.

The short answer to the contention that a deduction should be allowed for life insurance premiums is that 26 U.S.C. § 535(b) provides for specific adjustments in computing the accumulated taxable income. That section does not authorize an adjustment in the form of a deduction for life insurance premiums. The taxpayer argues that the amounts paid out for life insurance premiums no longer were available for distribution and should not be included in the measure of the tax because the tax is imposed on what is accumulated rather than on what is distributed. This generalization is not consistent with the rules established by the Internal Revenue Code for calculating the accumulated earnings tax. Since the Code does not allow the deduction urged by taxpayer, if his contention has any merit, it is for consideration of the Congress rather than for the courts.

The taxpayer also asserts that it has accumulated earnings over a period of sixty years and as a result thereof, the tax imposed in the present case is on capital and not upon income and hence, results in a violation of the Sixteenth Amendment. We find this contention to be without merit. *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46, 53.

Affirmed.

MEMORANDUM, FINDINGS OF FACT, AND OPINION OF THE TAX COURT

(52 T.C. No. 83)

(Filed August 11, 1969)

TAX COURT OF THE UNITED STATES

NOVELART MANUFACTURING COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 3483-67 Filed August 11, 1969

Held, that the petitioner has not shown that it was not availed of during the taxable years in question for the purpose of avoiding the income tax with respect to its shareholder by permitting its earnings and profits for such years to accumulate instead of being divided or distributed, and that it is therefore subject to the accumulated earnings tax imposed by section 531 of the Internal Revenue Code of 1954.

Sol Goodman, for petitioner.

Rodney G. Haworth, for respondent.

ATKINS, *Judge*: The respondent determined deficiencies in income tax in the amounts of $10,734.55, $12,132.17, and $6,172.21 for the fiscal years ended June 30, 1961, 1962, and 1963, respectively.

The only issue for our decision is whether petitioner was availed of for the purpose of avoiding the income tax on its shareholder by permitting its earnings and profits to accumulate instead of being divided or distributed, with the result that the petitioner is subject to the accumulated

earnings tax imposed by section 531 of the Internal Revenue Code of 1954. Some of the facts were stipulated and are incorporated herein by this reference.

FINDINGS OF FACT.

The petitioner is a Delaware corporation whose principal office at the time of the filing of the petition was in Cincinnati, Ohio. Its Federal income tax returns for the taxable years here involved were filed with the district director of internal revenue at Cincinnati, Ohio.

During the years in question all of petitioner's outstanding capital stock was owned by Charles H. Klein, who was also petitioner's president. Klein and his wife filed joint Federal income tax returns during the calendar years 1961, 1962, and 1963. The maximum tax rates applicable to their income for those years were 62 percent, 65 percent, and 65 percent, respectively.

The petitioner was originally organized in 1906 under the name of Progress Lithographing Company. It carried on a lithographing, printing, and binding business in several plants, one being in Amberley Village, Ohio, and one in Lebanon, Ohio, and also engaged in research and development activities in this field.

In 1958 petitioner had begun to experiment at its Lebanon plant with a process of lithographing cardboard for use in making corrugated cardboard boxes. Lithographing of such cardboard was a new concept, and at that time no other company was engaged in such an enterprise. In furtherance of this project, petitioner purchased some new machinery and, using it with its old facilities, began to lithograph the cardboard on an experimental basis. It employed a market research firm to study the market demand for such a product in order to determine whether to

continue the project. The results of the study were highly favorable, and the petitioner determined to enter this field on a commercial basis.

At a directors' meeting held on February 9, 1959, Klein informed the directors that he had begun a search for another plant site because of the necessity for additional factory space due to changing requirements of the business. He stated that it would be necessary to either expand the Amberley plant or build a new building on another site. The directors instructed Klein to prepare an outline of petitioner's anticipated future requirements with a comparison of the cost of a new plant addition and that of a complete new building on a new site.

The minutes of a meeting of the directors of petitioner held May 5, 1959, contain the following:

> Due to the company's undertaking the lithographing of folding boxboard during the past few years and its increasing volume, additional floor space for this kind of work and to serve the new machinery and equipment [being moved to the Amberley plant from another plant] is urgently required. Folding boxboard normally needs approximately five times as much floor space as paper stock of similar size because of the respective difference in thickness. The President also reported to the Directors that preliminary layouts were completed and floor plans would be ready at an early date for both a new factory addition and a complete new plant. The President was instructed to obtain preliminary cost estimates based upon these plans, so a decision could be reached to adopt either plan.

At a meeting held on July 15, 1959, the directors authorized expenditure of such sums as might be necessary to continue the promotion and development of proprietary products, subject to the control of Klein in the exercise of his best judgment.

About January 1, 1960, the petitioner's name was changed to Novelart Manufacturing Company, and a subsidiary was formed and given the name Progress Lithographing Company (hereinafter referred to as "Progress"). Petitioner then transferred to Progress all its manufacturing assets necessary to operate its lithographing, printing, and binding business, and received in exchange, among other things, 80 percent of the voting stock of Progress. Thereafter Progress carried on the operating business previously engaged in by petitioner, while petitioner continued its research and development activities.

Progress undertook to carry on the business of lithographing cardboard. However, it did not achieve the financial results which it sought and it produced only limited quantities of lithographed cardboard. Klein then conceived the idea of fabricating the lithographed cardboard into boxes. It was not then definitely decided whether petitioner or Progress would perform this fabrication process. This fabrication would require additional manufacturing space, and in January or February 1962 the petitioner examined a plant at 4501 West Mitchell Avenue in Cincinnati, which had previously been used as a box factory. This plant consisted of a building which contained over 100,000 square feet, was located on a railroad siding and was accessible to Progress' plant, and had machinery which could be utilized after modification. This plant would provide both manufacturing and storage space. The asking price for this plant at that time was about $1,500,000. However, there were no takers and the petitioner felt that the price was too high. In August 1962, petitioner reexamined the plant, at which time the asking price had been reduced, but the petitioner still believed the price to be too high. The petitioner continued to negotiate for the plant, and in September 1962 entered into a contract to purchase

it for $530,000. The property was transferred to the petitioner on November 12, 1962. The total cost of the acquisition was $532,000.

Thereafter, in the latter part of 1962, the president of Progress, Sundermann, died, which disrupted the plan with respect to the utilization of the Mitchell Avenue plant. Such property remained vacant for about a year, after which time petitioner rented it to Litho Carton and Container Company (formerly R.A. Taylor Corporation) a subsidiary of Progress.

About the end of 1962 Klein and two of his associates conceived the idea of a new type of machine for manufacturing corrugated paper board which would permit the offering of a greater variety of sizes of paper for the manufacture of cartons and would at the same time result in faster production and less cost. In view of this new development, Progress ceased lithographing cardboard in order to modify its facilities. Due to the death of Sundermann the machinery changeover was not accomplished until sometime in early 1963. In the spring of 1963 Progress resumed operations, employing the new process. Klein and his associates filed an application for a patent on the new type of machine on May 20, 1963, and the patent was eventually issued on February 28, 1967, and was assigned to the petitioner.

Sometime in 1967 the petitioner purchased a plant in North Vernon, Indiana, at a cost of between $750,000 and $1,000,000.[1] At the time of the trial in 1968 machinery was

1. The need for an additional plant was discussed at a meeting of the petitioner's board of directors on June 20, 1966, the minutes of which state in part:

> The Directors then discussed the property owned by the Corporation and located at 4501 West Mitchell Avenue. This property is presently rented to the corporation's subsidiary. It was brought out in the discussion that this building is rapidly being filled with machinery, raw materials, work-in-

in process of being built for the plant and petitioner anticipated that the total cost of the plant and work in process might run to $1,500,000.

During the taxable years in question petitioner had no specific and definite plan to purchase this or any other particular plant, aside from the Mitchell Avenue plant. It did contemplate that at some time in the future some expenditure would be made for additional plant facilities, but it was not known what amount would be expended since this would depend upon the market at the time of purchase and the facilities that would be required.

The minutes of a meeting of petitioner's directors held on July 15, 1959, contain the following:

> RESOLVED: That the expenditure of such sums as are necessary to continue the promotion and development of proprietary products are hereby authorized subject to the control of Charles H. Klein, President, in the exercise of his best judgment.
>
> * * *
>
> Discussion followed concerning continuation of established policies of acquisition and expansion. * * * The President indicated that he would continue his activities with respect to the purchase of other companies as he felt each acquisition would be carefully considered on its own merits when presented.

The minutes of the meeting of June 17, 1960, contain the following statement:

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process and finished goods inventories. The Directors were reminded that when this building was purchased, it was at that time considered in the nature of a stop-gap because of the subsidiary's need for space to meet the increasing requirements of the PRE-LITH corrugated larger building. They were reminded that it is customary for 500 sheets of PRE-LITH corrugated material to be stacked on a single skid. With the subsidiary now receiving single orders amounting to hundreds of thousands of pieces, it is apparent that increased space will be needed.

Charles H. Klein, President, stated that the major purpose of the meeting was to consider the utilization of the corporation's earnings and profits for the current fiscal year and to consider the reasonably anticipated needs of this corporation's business and the business of Progress Lithographing Company with respect to said earnings and profits. He pointed out that the officers and directors of this corporation and of Progress, in which latter corporation this corporation owns 80% of the voting common stock, have undertaken an active program to acquire other business enterprises through purchasing the capital stock or assets of other corporations; and in view of this business acquisition program he stated that in his judgment there should be no declaration of dividends in excess of $30.00 per common share by the Directors of this corporation with respect to the corporation's earnings and profits for the current fiscal year. He pointed out further that this business acquisition program will require the utilization of the current year's earnings and profits by this corporation to acquire these businesses or by Progress to acquire such businesses.

* * *

RESOLVED: That the proper officers of the corporation be and they are hereby authorized and directed to take all necessary action to carry out the aforesaid business acquisition program on behalf of this corporation and of Progress Lithographing Company and to utilize the earnings and profits of this corporation for such business acquisitions.

The minutes of a meeting held on July 26, 1960, contain the following:

Discussion followed concerning continuation of established policies of acquisition, investment and expansion. The President indicated that he would continue his activities with respect to the purchase or investment in other companies and would bring to the attention of the Board of Directors each situation deemed

worthy of consideration on its own merits within the framework of the resolution adopted as an Amendment to the Articles of Incorporation at the Special Meeting of Stockholders held on December 28, 1959.

The minutes of a meeting held on June 18, 1960, contain the following:

> The President then stated that he had been continuing discussions with U. Gordon Colson, President, of U. O. Colson Company with respect to the acquisition by this corporation of a capital stock interest in the U. O. Colson Company; and that these discussions up to this point have been successful. The President further advised that in all probability he would be elected to the Board of Directors of the U. O. Colson Company and that this corporation would be afforded the opportunity to make a considerable investment in the capital stock of the U. O. Colson Company. After discussion and upon motion duly made, put, seconded, and unanimously carried, the following resolutions were adopted:
>
> RESOLVED: That Charles H. Klein, President, be and hereby is authorized to take all necessary action to invest funds of this corporation in the capital stock of the U. O. Colson Company.

* * *

In 1957 or 1958 Klein first became interested in the possibility of purchasing for petitioner an interest in the U. O. Colson Company, which manufactured lithographed calendars. That company was not a supplier, customer or competitor of petitioner. Sometime after June 18, 1960, Klein was elected a director of U. O. Colson Company. From time to time Klein discussed with its president, who owned a majority interest and who was anxious to get some capital out of the business, the possibility of the purchase of an interest. However no interest was

purchased and in late 1967, when the assets of the Colson Company were sold, Klein abandoned any thought of purchasing any interest in such company.

Sometime prior to July or August 1960, petitioner became interested in producing paper shredding machines for sale for office use, and considered purchasing a company already in that business. However, due to the fact that such business was not protected by a patent, petitioner decided instead to establish a business of its own in that field. Establishing such a business involved the designing of a product, the building of manufacturing equipment and the establishment of manufacturing and sales operations which, if carried to the point of distribution and sale, would have involved expenditures of $200,000 to $300,000. In July or August 1960, a subsidiary, Electroshred Corporation, was formed to carry on this operation. However, due to the unexpected death of Progress' president toward the end of 1962, Klein was forced to direct his energy to the active management of Progress, and this paper shredding project was discontinued. During the years here in question, petitioner invested about $50,000 in this venture.

In November 1960, petitioner began a "plastic lid project". At that time lids for containers such as cottage cheese cans were being made of metal. Petitioner originally planned both to print a design upon plastic discs, and to form the plastic discs into lids. The R. C. Can Company, a large paper manufacturing company, was also considering the manufacturing of plastic lids. It prevailed upon petitioner to agree to make only the round disc and imprint it, and permit R. C. Can Company to form it into a finished lid. Petitioner then originated some designs, developed a production process and a material to hold the design on the plastic, purchased and installed

machinery, hired employees, and went into experimental production of the imprinted plastic discs. However, when petitioner's printed discs were placed in the forming machinery operated by R. C. Can Company the inked designs were damaged. Also, the R. C. Can Company learned that it would have to have a special set of costly molds, and several machines, for each of its customers. The R. C. Can Company determined to discontinue their work on the plastic lid project, and petitioner started negotiations to buy the machinery from that company. A contract was drawn for the sale of the machinery to petitioner for $115,000 and was signed by the president of R. C. Can Co. Petitioner prepared its plant to receive the machinery, but after a last minute consultation with a large customer of R. C. Can Company, who advised against the project, petitioner withdrew from the deal. This occurred in about November 1961. During the year it worked on this project petitioner purchased some machinery at an undisclosed cost and used some which it already owned.

Sometime in 1960 Klein learned that a block of approximately 10 percent of the outstanding stock of Crystal Tissue Company was for sale for about $100,000. Crystal Tissue Company had been in the business of producing and selling decorated gift wrapping paper. Petitioner had done the lithographing work for that company which had for a while been petitioner's largest customer. However, such company had reached a point where it needed to rebuild its plant and two years earlier it had terminated operations, and petitioner had purchased its designs. The company intended to resume business of selling other consumer products. Klein thought it would be beneficial to petitioner to obtain an interest therein. His negotiations for the stock reached a point at which he thought a

purchase had been consummated. Instead, such block of stock was sold to the family which controlled Crystal Tissue. Petitioner, however, prior to these negotiations had purchased a small part of that company's outstanding stock for $500.

Sometime prior to January 1961, on petitioner's behalf, Klein had discussions with A.P.S. Company, a new corporation composed of the American Paper Specialty Company and two other companies. The American Paper Specialty Company had previously manufactured gift wrapping paper and similar items and the new company was formed to continue that business. Due to Klein's friendship with the persons who were forming the company he was invited to purchase some of its stock. In January 1961, petitioner purchased for $150,000 a 10 percent interest in A.P.S. Company and Klein became one of the directors. As a consequence, A.P.S. Company became a customer of Progress.

About April 1961, Klein became acquainted with the owner of the J.J. Hackett Company, a manufacturer of tabulating machine cards. Petitioner had never made a similar product, but Klein wanted to get in this new type of printing. The J.J. Hackett Company had plants in Chicago and Cincinnati, and Klein and the president of Hackett agreed to set up, as a separate corporation, a third plant in Detroit. Petitioner furnished 75 percent of the capital required by the new corporation, receiving 75 percent of the stock, and the J.J. Hackett Company furnished its experience as well as the remainder of the required capital. In addition, petitioner furnished the machinery for the new operation, for which it received rent from the new corporation. During the years involved herein, petitioner's total investment in capital and machinery for the new corporation was $50,000.

In May 1961, petitioner purchased, for $275,000, the Rapid American Building, a building occupied by three companies operating in the field of graphic arts. One of the occupants of the building, the Rapid Electrotype Company, was also offered for sale to petitioner, but petitioner did not purchase it.

In June 1961, petitioner purchased an interest in Magna Company for $72,000. That company was located in Cincinnati, but the record does not disclose what business it carried on. Klein negotiated the purchase as an investment and also for the purpose of attempting to obtain that company as a customer. Such company did become a customer, presumably of Progress.

In November 1961, Klein, on petitioner's behalf, began investigating the possibility of purchasing the John Baumgarth Company, a calendar manufacturer. Apparently the asking price was about $2,500,000. Klein received figures relating to the company's finances, visited its plant, and hired a company to research and report on the past history, present operations, and future prospects of the company in detail. Petitioner learned that Baumgarth (presumably the owner) had been in bankruptcy three or four times previously. After receiving the research report petitioner lost interest in acquiring such company.

In March 1963, Klein began discussions with the owners of Artistic Greeting Card Company, a company for which petitioner had acted as a supplier for 15 years with a view to a possible acquisition of an interest in that company. The family which owned that company desired to dispose of the business but to provide for future participation in the business by a young member of the family. Accordingly, they proposed to sell petitioner a 50 percent interest for about $1,900,000 and the young member of the

family the remaining 50 percent interest for $100,000. It was pointed out to petitioner that such person would also contribute his experience and other "intangible assets". Klein visited the plant several times and in August 1963, petitioner's tax counsel was permitted to examine the company's financial records. Thereafter a complete report was made. Klein met with the owners of the company in December 1963, at which time he proposed that petitioner make payment over a period of years and that a portion of the payment be made out of future profits of Artistic. The owners would not agree to this. As a consequence, Klein concluded that the owners lacked confidence in the future of the business, and decided the petitioner should not assume the risk involved when the owners refused to assume any part of the risk. He therefore broke off negotiations at that time. At no time was there any fear that petitioner would lose the Artistic Greeting Card Company as a customer.

At some undisclosed time during the years in question, Klein learned that a large block of stock in the Manz Company was for sale. The Manz Company was one of the largest lithography companies in Chicago, with a large well-equipped plant. It did a nationwide business. Klein travelled to Chicago, and learned that all or substantially all the stock of the company could be purchased for about $2,000,000 to $2,500,000. He was told that the company was in poor condition because new management "hadn't worked out" and "had thrown away a lot of money." Klein inspected the plant 2 or 3 times within a 2-week period, and, as a result of such visits, he determined that much of the work on hand did not represent orders from customers, but represented work done without charge to attract business. He took his tax counsel on one visit, at which time the company's finances were examined in detail. Klein came to the conclusion that the company was a desirable

purchase for the petitioner, but, since there were going to be further changes in the management, he thought it best to wait to see the results of those changes. However, another party bought the company for $2,200,000. The purchaser then offered to sell petitioner an interest in its combined companies, but petitioner declined the offer.

During the taxable years ended June 30, 1961, 1962, and 1963, petitioner paid net premiums of $24,857.05, $22,212.35, and $21,495.40, respectively, on life insurance policies on its officers and employees. The face values of these policies totalled $955,000. Of such premiums, the amounts of $22,350.20, $21,470.95, and $20,835.40 related to policies on the life of Klein, inasmuch as $875,000 of the total of face values of the policies was on his life.

The petitioner's accumulated earnings and profits as of the end of each of the taxable years in question were as follows:

Date	Accumulated Earnings and Profits	Increase Over Accumulation Beginning of Year
July 1, 1960	$4,772,080.74	—
June 30, 1961	4,919,779.18	$147,698.44
June 30, 1962	5,045,466.44*	125,687.26
June 30, 1963	5,131,035.42*	85,568.98

*The petitioner's returns show earned surplus and undivided profits at the end of these two years of $577,668.77 and $663,237.75, respectively, due to the fact that on October 16, 1961, an amount of $4,467,797.67 was transferred from its earned surplus account to its capital stock account.

Petitioner's assets and liabilities as of the beginning and end of each of the taxable years ended June 30, 1961 through 1963, were as follows:

ASSETS	July 1, 1960	June 30, 1961	June 30, 1962	June 30, 1963
Cash	$1,558,234.34	$1,948,251.20	$2,112,230.50	$1,768,253.27
Gov't Obligations	995,399.82	–0–	–0–	–0–
Notes & Accts. Receivable	103,917.38	47,071.98	98,308.36	26,625.52
Inventories	–0–	12,101.83	10,668.41	10,343.41
Investment in & amounts due from subsidiaries	1,527,327.06	1,645,369.28	1,502,807.98	1,573,537.37
Stocks, bonds, etc.	482,740.03	682,356.75	753,967.41	899,670.12
Bldgs. & depreciable assets	508,305.20	750,790.39	698,412.46	1,111,619.65
Land	35,407.85	88,515.63	88,515.63	117,345.63
Work in Process	348.75	348.75	348.75	348.75
Cash value of life insurance	186,209.05	209,412.96	228,316.14	252,566.58
Other assets	6,202.73	8,236.41	5,673.40	5,219.09
Total	$5,404,092.21	$5,392,445.18	$5,499,249.04	$5,765,529.39
LIABILITIES				
Accts. Payable	$ 12,208.55	$ 12,122.39	$ 12,845.15	$ 20,623.31
Mortgages, Notes and Bonds payable in less than 1 year				250,000.00
Salaries, Taxes, etc.	190,300.00	33,309.60	94,691.46	16,581.66
Deferred Federal taxes on income	250,000.00	250,000.00	187,500.00	187,500.00
Other Liabilities	27,300.59	25,031.68	6,643.66	7,586.67
Total	$ 479,809.14	$ 320,463.67	$ 301,680.27	$ 482,291.64

On its Federal income tax returns for the taxable years ended June 30, 1961 through 1963, the petitioner described its principal business activity as "Investments and Lessor of buildings." In such returns it reported taxable income computed as follows:

	1961	1962	1963
Net receipts:	$ 15,423.77	$ 1,828.62	$ 910.98
Less cost of goods sold:	28,164.86	7,691.17	1,741.79
Gross profit:	(12,741.09)	(5,862.55)	(830.81)
Dividends:	18,421.25	19,959.51	10,506.32
Interest:	105,391.82	157,096.03	103,316.18
Rents:	136,041.65	103,200.00	153,946.13
Net gains from sales of property:	1,484.82	236,498.03	23,275.94
Other income:	2,423.19	12.50	33.88
Total income:	$251,021.64	$510,903.52	$290,247.64
Total deductions:	160,449.17	180,453.59	215,385.30
Taxable income before special deductions:	$ 90,572.47	$330,449.93	$ 74,862.34
Special deductions (dividends received):	16,658.06	16,924.24	8,910.38
Taxable income:	$ 74,914.41	$313,525.69	$ 65,951.96

With respect to companies from whom petitioner reported having received dividend income during the years in question, it owned a controlling interest in only Progress, from which it received dividends of $3,200 each year. Of the dividends received in those years, at least $12,929.75, $12,702.28, and $3,675.83, respectively, was received from companies which were in no way related to petitioner, principally from Twin Coach Company, but also from such companies as Schenley Industries, Inc., Texas Gulf Sulphur Company, James B. Beam Distributing Co., and General Motors.

During each of the taxable years here involved, petitioner paid dividends of $15,400 to its shareholder. It paid salary to Klein at an annual rate of $42,000.

On February 17, 1967, respondent, pursuant to section 534(b) of the Internal Revenue Code of 1954, notified petitioner that he proposed to issue a notice of deficiency for the taxable years ended June 30, 1961 through June 30, 1963, setting forth an amount with respect to section 531 of the Code relating to the accumulated earnings tax. On April 13, 1967, petitioner, pursuant to section 534(c) of the Code, submitted a statement of the grounds on which it relied to establish that its earnings and profits had not been permitted to accumulate beyond the reasonable needs of its business.

By notice of deficiency dated June 2, 1967, the respondent determined that in each of the taxable years ended June 30, 1961, 1962, and 1963, the petitioner had permitted its earnings and profits to accumulate beyond the reasonable needs of its business for the purpose of avoiding the income tax with respect to its shareholders, and that the petitioner was taxable under the provisions of section 531 of the Code. Therein he determined that for each of the taxable years in question the petitioner was a holding or investment company within the meaning of section 533(b) of the Code. He determined accumulated taxable income for those years in the respective amounts of $39,034.73, $44,116.98, and $22,444.41. In his computation of accumulated taxable income the respondent did not allow any accumulated earnings credit.

On February 23, 1968, petitioner moved that this Court find that its statement filed pursuant to section 534(c) was sufficient to place the burden of proof on respondent with respect to the grounds set forth in the statement on which the petitioner relied to establish that its earnings and profits had not been permitted to accumulate beyond the reasonable needs of its business. After hearing was had up-

on such motion on March 27, 1968, this Court, on April 5, 1968, entered an order denying the motion.

ULTIMATE FINDING OF FACT.

During each of the taxable years ended June 30, 1961, 1962, and 1963 the petitioner permitted its earnings and profits to accumulate beyond the reasonable needs of its business.

OPINION.

The accumulated earnings tax imposed by section 531 of the Internal Revenue Code of 1954 applies, with certain exceptions, to any corporation formed or availed of for the purpose of avoiding the income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed. There are set forth in the margin pertinent sections of the Internal Revenue Code of 1954.[2]

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2. SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax * * *.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) General Rule.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) Unreasonable Accumulation Determinative of Purpose.—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate be-

Section 533(b) provides that the fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders. One of the respondent's contentions is that during the taxable years in question the petitioner was such a mere holding or investment company, stating, among other things, that practically all of petitioner's income reported was passive, namely, dividends, interest, rent, and gains from the sales of stocks

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yond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) Holding or Investment Company.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

* * *

(c) Accumulated Earnings Credit.—

(1) General rule.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). * * *

* * *

(3) Holding and investment companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

* * *

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

or securities. He cites section 1.533-1(c) of the Income Tax Regulations.[3] The petitioner denies that it was a mere holding or investment company, contending that it was actively engaged in research and development, a search for diversification, and the acquisition of additional plants, even though the production was carried on through subsidiaries.

We find it unnecessary to resolve the issue of whether the petitioner was a mere holding or investment company, since, irrespective of that question, it is our opinion that the petitioner has failed to meet its burden of showing that it was not availed of for the purpose of avoiding the tax on its sole shareholder, Charles H. Klein.

The respondent also contends that the petitioner's earnings and profits for the years in question were accumulated beyond the reasonable needs of its business. Section 533(a) provides that the fact that the earnings and profits are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary. The burden of proof was upon the petitioner to show that the earnings and profits were

3. Such regulation provides as follows:

Holding or investment company. A corporation having practically no activities except holding property and collecting the income therefrom or investing therein shall be considered a holding company within the meaning of section 533(b). If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 533(b).

not permitted to accumulate beyond the reasonable needs of the business.[4]

The petitioner's principal contention appears to be that throughout the three taxable years in question it actually expended more for plant and equipment than the total of its earnings and profits for those years available for distribution, and that therefore it cannot be considered that such earnings and profits were accumulated beyond the reasonable needs of its business, but it also stated as a reason for its accumulations that the acquisition of plants looked at and negotiated for would have required an investment of up to $5,000,000. We have consistently held that in determining whether the earnings and profits of any taxable year have been accumulated beyond the reasonable needs of the business, it is necessary to consider whether accumulated earnings and profits of prior years were sufficient to meet the taxpayer's reasonable business needs of the taxable year, including reasonably anticipated needs. There must, of course, be taken into consideration the availability of the prior years' accumulated surplus. Thus, to the extent that such accumulated surplus has been translated into plant expansion or inventories or other assets related to the business, it is not available for meeting current or anticipated business needs. On the other hand, at least to the extent that such accumu-

4. In this connection it should be pointed out that on brief the petitioner makes the argument that in view of the statement which it submitted, pursuant to section 534(c) of the Code, the burden of proof is upon the respondent with respect to the grounds stated therein upon which petitioner relied to establish that its earnings and profits had not been permitted to accumulate beyond the reasonable needs of its business. However, as pointed out in the Findings of Fact, prior to trial this Court entered an order denying the petitioner's motion that the Court find that such statement was sufficient to place the burden of proof in this respect upon the respondent. The intention of the Court and the effect of the order was to hold, in advance of the trial, that the petitioner's statement was not sufficient to place the burden of proof upon the respondent, and that such burden remained upon the petitioner.

lated surplus is reflected in liquid assets, it is available to meet business needs, and if sufficient to meet the current and reasonably anticipated business needs of the corporation there is a strong indication that any accumulation of earnings and profits of the current year is beyond the reasonable needs of the business. *Wellman Operating Corporation,* 33 T.C. 162; *John P. Scripps Newspapers,* 44 T.C. 453; *Smoot, Sand & Gravel Corporation* v. *Commissioner,* (C.A. 4) 274 F.2d 495, certiorari denied 360 U.S. 976, affirming a Memorandum Opinion of this Court; section 1.535-3 (b) (1) (ii) of the Income Tax Regulations; and S. Rept. No. 1622, 83d Cong., 2d Sess., p. 317.[5]

Here the petitioner, as of the beginning of the taxable year ended June 30, 1961, had accumulated earnings and profits from prior years in the amount of $4,772,080.74, of which $1,553,234.34 was represented by cash and $1,478,139.85 was represented by investments in Government obligations and stocks, bonds and other securities. It is against this background that we must consider whether the earnings and profits of the taxable years in question were permitted to accumulate beyond the reasonable needs of the business.

The reasonable needs of a business include the reasonably anticipated needs of such business. Section 537 of the Code. However, where the future needs of the business, as determined in the light of the facts existing as of the end of the taxable year, are uncertain or vague or the plans for the future use of an accumulation are not specific and definite, an accumulation cannot be justified

5. Such report states in part:

> In determining the portion, if any, of the earnings and profits for a taxable year which may be retained for the reasonable needs of the business, and amount of the earnings and profits accumulated in prior years shall, of course, be taken into account.

on the grounds of reasonably anticipated needs. See section 1.537-1(b) of the Income Tax Regulations,[6] and H. Rept. No. 1337, 83rd Cong., 2nd Sess., p. A173.[7]

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6. Such section provides in part as follows:

(b) *Reasonably anticipated needs.* (1) In order for a corporation to justify an accumulation of earnings and profits for reasonably anticipated future needs, there must be an indication that the future needs of the business require such accumulation, and the corporation must have specific, definite, and feasible plans for the use of such accumulation. Such an accumulation need not be used immediately, nor must the plans for its use be consummated within a short period after the close of the taxable year, provided that such accumulation will be used within a reasonable time depending upon all the facts and circumstances relating to the future needs of the business. Where the future needs of the business are uncertain or vague, where the plans for the future use of an accumulation are not specific, definite, and feasible, or where the execution of such a plan is postponed indefinitely, an accumulation cannot be justified on the grounds of reasonably anticipated needs of the business.

(2) Consideration shall be given to reasonably anticipated needs as they exist on the basis of the facts at the close of the taxable year. Thus, subsequent events shall not be used for the purpose of showing that the retention of earnings of profits was unreasonable at the close of the taxable year if all the elements of reasonable anticipation are present at the close of such taxable year. However, subsequent events may be considered to determine whether the taxpayer actually intended to consummate or has actually consummated the plans for which the earnings and profits were accumulated. In this connection, projected expansion or investment plans shall be reviewed in the light of the facts during each year and as they exist as of the close of the taxable year. If a corporation has justified an accumulation for future needs by plans never consummated, the amount of such an accumulation shall be taken into account in determining the reasonableness of subsequent accumulations.

7. Such House Report provides as follows:

It is intended that this provision will make clear that there is no requirement that the accumulated earnings and profits be invested immediately in the business so long as there is an indication that future needs of the business require such accumulation. In any case where there exists a definite plan for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulations are indefinite, the amendment does not prevent application of the accumulated earnings tax.

It should be further observed that the need to retain earnings and profits must be directly connected with the needs of the corporation itself and be for bona fide business purposes (section 1.537-1(a) of the Income Tax Regulations), but that the business of the corporation is not merely that which it has previously carried on but includes any line of business which it may undertake. Section 1.537-3 of the regulations[8] provides that the business of a corporation may include the business of another corporation if such other corporation is a mere instrumentality of the first corporation, and that this may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. However, if the ownership of stock in the second corporation is less

8. Section 1.537-3 of the regulations provides as follows:

Business of the corporation.—(a) The Business of a corporation is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake.

(b) If one corporation owns the stock of another corporation and, in effect, operates the other corporation, the business of the latter corporation may be considered in substance, although not in legal form, the business of the first corporation. However, investment by a corporation of its earnings and profits in stock and securities of another corporation is not, of itself, to be regarded as employment of the earnings and profits in its business. Earnings and profits of the first corporation put into the second corporation through the purchase of stock or securities or otherwise, may, if a subsidiary relationship is established, constitute employment of the earnings and profits in its own business. Thus, the business of one corporation may be regarded as including the business of another corporation if such other corporation is a mere instrumentality of the first corporation; that may be established by showing that the first corporation owns at least 80 percent of the voting stock of the second corporation. If the taxpayer's ownership of stock is less than 80 percent in the other corporation, the determination of whether the funds are employed in a business operated by the taxpayer will depend upon the particular circumstances of the case. Moreover, the business of one corporation does not include the business of another corporation if such other corporation is a personal holding company, an investment company, or a corporation not engaged in the active conduct of a trade or business.

than 80 percent the determination of whether the funds are employed in a business operated by the first corporation will depend upon the circumstances of the case. See also H. Rept. No. 1337, 83rd Cong., 2nd Sess., p. 53.[9] The regulations further provide that an accumulation for the purpose of acquiring a business enterprise through the purchase of stock or assets, or to make investments or loans to suppliers or customers if necessary to maintain the corporation's business, may constitute an accumulation for the reasonable needs of the business. Section 1.537-2(b) of the Income Tax Regulations. However, accumulations of earnings and profits to make investments in properties or securities which are unrelated to the activities of the business of the taxpayer-corporation may not be considered as accumulations to meet the reasonable needs of the business. See *Kerr-Cochran, Inc.*, 30 T.C. 69, and section 1.537-2(c) of the Income Tax Regulations.

On or about January 1, 1960, the petitioner transferred all its manufacturing assets to its subsidiary, Progress, and thereafter, throughout the years in question, that company carried on the lithographing business previously carried on by the petitioner, and the petitioner thereafter continued its research and development activities in the field of

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9. H. Rept. No. 1337, 83rd Cong., 2nd Sess., contains the following at p. 53:

> Another subject of controversy in the administration of section 102 has been the use of retained earnings for the purpose of acquiring another business enterprise. Under existing interpretations, retained earnings may be invested in a business enterprise operated directly by the taxpayer, but doubt exists as to the operation of such a business through a subsidiary corporation controlled by the taxpayer. Your committee is of the opinion that where the taxpayer has 80 percent or more of the voting stock of another corporation, the taxpayer should be viewed as though it engaged directly in the business of such other corporation. If the taxpayer's ownership of stock is less than 80 percent in such other corporation, a factual determination should be made as to whether the funds so invested are employed in a business operated by the taxpayer. * * *

lithography. However, since petitioner owned 80 percent of the voting stock of Progress, the business of the latter will be considered as the business of the petitioner.

As of the end of the taxable year ended June 30, 1961, there existed a need for additional plant space to carry out the existing lithography business then being carried on by Progress. In 1959 the board of directors had instructed Klein, its president, to obtain preliminary cost estimates in order that a decision could be made as to whether a new plant should be built or an existing plant expanded. The evidence does not show whether, as of the end of the taxable year ended June 30, 1961, that decision had been made and, if so, the anticipated cost involved. However, the evidence does show that approximately 6 months after the close of such year the petitioner started negotiations for buying an existing plant, the Mitchell Avenue plant. The asking price was $1,500,000, but the petitioner considered that price too high and finally, in September 1962, such plant was purchased by petitioner for $532,000. Under these circumstances, we think it reasonable to conclude that as of the end of the taxable year ended June 30, 1961, one of the reasonably anticipated needs of the business was additional plant space to cost approximately $532,000. This was also the situation at the end of the taxable year ended June 30, 1962.

Sometime in 1967, which was at least three and a half years after the close of the last taxable year here involved, the petitioner purchased a plant in North Vernon, Indiana, at a cost between $750,000 and $1,000,000. The evidence shows that during the taxable years here involved the petitioner had no specific and definite plan to purchase this or any other particular plant, other than the Mitchell Avenue plant. And, although Klein testified that it was contemplated that some expenditure would be made for a plant

at some time in the future, he also stated that it was not known how much would be spent since that would depend upon the market and the facilities which would be required. Thus, during the taxable years here involved the petitioner's future plant needs were so vague and uncertain and its plans for the future use of funds for that purpose so indefinite that we cannot conclude that it had any reasonably anticipated need for funds for plant acquisition over and above the above anticipated expenditure of $532,000.

Minutes of meetings of the board of directors of the petitioner state that the officers and directors had undertaken a program of acquiring other business enterprises. Such policy was general in nature and it was contemplated that Klein would first investigate any possible acquisitions before determining which were worthy of consideration. In determining the reasonably anticipated needs of the business in this respect there may be taken into consideration only those plans for acquisitions which, as of the end of a particular taxable year, were specific and definite.

In 1957 or 1958 Klein became interested in the possibility of purchasing for petitioner an interest in the U. O. Colson Company, which manufactured lithographed calendars, but which was not a supplier, customer or competitor of the petitioner. In June 1960 the board of directors of petitioner authorized Klein to take necessary action to invest funds, the amount being unspecified, of the petitioner in the capital stock of that company. Klein became a director of the Colson Company and from time to time discussed with its president, U. Gordon Colson who owned a majority interest, the possibility of purchasing an interest. However, the petitioner never did acquire an interest in that company, and Klein testified that "the

thought of acquiring the company continued" until late 1967[10] when the assets of such company were sold to another. While in his testimony Klein spoke of acquiring the company, the record fails to show how much the petitioner had in mind might be invested in the Colson Company or how much of an interest in that company might be purchased. Klein testified that he "didn't feel it was worth an investment of a million and a half dollars and we didn't go any further." Whether the amount referred to by Klein represented the asking price for Colson's majority interest, or some other percentage interest, we cannot determine from the evidence. In any event, the record falls far short of establishing that the petitioner had in mind acquiring the business enterprise and operating it. Rather, insofar as the record shows, the intention was merely to make an investment in the stock of the Colson Company, which would represent an investment in securities unrelated to the petitioner's business activities. Furthermore, the record does not establish to our satisfaction that as of the end of any of the taxable years before us there was a specific and definite plan to purchase an interest in the Colson Company. We are not informed as to when Klein decided that it was not advisable to invest as much as was apparently asked for an interest in the Colson Company. For all that appears, this may have happened during the taxable year ended June 30, 1961, and thereafter there was no definite expectation or intention of acquiring an interest in that company. Accordingly, the petitioner has not established that as of the end of any of the taxable years in question there was a reasonable

10. The transcript of testimony shows the time as "late 1957." However, such date is obviously incorrect since it was not until June 18, 1960, that petitioner's board of directors considered the matter of investment in that company. From the record we think it reasonable to conclude that the correct time was "late 1967." However, whether it was late 1967 or some other date after June 18, 1960, is, in our opinion, immaterial.

business need for funds for the purpose of acquiring an interest in the Colson Company.

In July or August 1960, the petitioner set up a subsidiary, Electroshred Corporation, to enter into the production of paper shredding machines. It was anticipated that from $200,000 to $300,000 would be expended in this venture. The evidence shows that during the three taxable years before us the petitioner invested about $50,000 in this project, but the amount invested in each year is not shown. Accordingly, viewing the situation as it existed at the end of the taxable year ended June 30, 1961, we think there was a reasonably anticipated need of the business of petitioner of about $250,000 for this purpose. This was also the situation at the end of the taxable year ended June 30, 1962. However, in the taxable year ended June 30, 1963, due to unforeseen circumstances, the project was abandoned, with the result that thereafter there was no further need in this respect.

During the taxable year ended June 30, 1961, the petitioner undertook a "plastic lid project" under an agreement with another company which provided that the petitioner would perform a part of the manufacturing process. The evidence is not clear as to how much was spent on the project or when any expenditures were made. Klein testified that petitioner bought some machinery and used some it already owned, so that petitioner "had like a hundred thousand dollars" worth of machinery and time in it for the year it worked on the project. Nor does the evidence establish what amount, if any, might represent the reasonably anticipated need of the petitioner with respect to this project as of the end of the taxable year ended June 30, 1961. During the taxable year ended June 30, 1962, the project was abandoned.

Sometime in 1960 petitioner attempted to purchase a 10 percent interest in Crystal Tissue Company, the asking price of which was $100,000. However, at an undisclosed time someone else purchased the interest. The evidence with regard to this prospective purchase is so meager that we cannot determine whether or not it was in prospect at the end of the taxable year ended June 30, 1961. In addition, it is not established that the purpose in purchasing such an interest would be to maintain the petitioner's business rather than merely make an investment in securities unrelated to petitioner's business activities. Under the circumstances, we cannot find that as of the end of any one of the taxable years in issue there was a reasonable business need for such an investment.

In January 1961, the petitioner purchased for $150,000 a 10 percent interest in A.P.S. Company. Since, as a consequence, that company became a customer of Progress, such expenditure might be considered as satisfying a reasonable need of petitioner's business. However, there is no showing that as of the end of any of the taxable years in question there was any need for further accumulation in connection with such acquisition.

At some undisclosed time after April 1961, the petitioner and the president of J.J. Hackett Company set up a new corporation for the purpose of manufacturing tabulating machine cards, the petitioner acquiring 75 percent of the stock. Since we do not know when this transaction occurred, we do not know whether at the end of any of the taxable years involved herein, the petitioner had any reasonably anticipated need for funds with respect to this project. All we know is that the petitioner's total investment in capital and machinery for the new corporation was $50,000 during the three taxable years involved herein, but we do not know how much was invested in each year.

In May 1961, petitioner purchased, for $275,000, the Rapid American Building. We are not persuaded by the evidence that petitioner intended to use this building for any purpose other than rental. In any event, there is no showing that as of the end of any of the taxable years there was any need for further accumulations in connection with such acquisition.

In June 1961, the petitioner purchased an interest in Magna Company for $72,000. Since one of the purposes was to obtain that company as a customer the expenditure may well have satisfied a reasonable need of petitioner's business. However, there is no showing that as of the end of any of the taxable years in question there was any need for further accumulations in connection with the interest acquired in such company.

In November 1961, Klein, on petitioner's behalf, began investigating the possibility of purchasing the John Baumgarth Company, the asking price for which was about $2,500,000. However, at some undisclosed time, after receiving a research report, the petitioner abandoned any idea of acquiring this company. Under the circumstances, we cannot find that as of the end of either of the taxable years ended June 30, 1962 or June 30, 1963, the petitioner had any reasonably anticipated need for funds with respect to the purchase of such company.

In March 1963 Klein commenced discussions with the owners of Artistic Greeting Card Company with regard to the possible acquisition of an interest in that company. The family which owned that business proposed to sell petitioner a 50 percent interest for about $1,900,000 and the remaining 50 percent interest to a younger member of the family for $100,000, it being pointed out to petitioner that such member of the family would also contribute his experience and certain "intangible assets." Klein's investi-

gation of the company, which included inspection of the company's financial records by petitioner's tax attorney in August 1963, continued until December 1963 when Klein decided that it would be inadvisable for petitioner to assume the risk of such an undertaking, and therefore broke off all negotiations. The evidence is so meager that we must conclude that petitioner has not shown that it ever contemplated the possibility of acquiring the business enterprise and operating it, as distinguished from making a passive investment therein. The fact that the proposal was to have a member of the family of the owners of the business pay such a small amount for a half interest, as compared with the petitioner's proposed payment, coupled with the fact that such family member was to contribute his experience and other benefits to the business, casts doubt upon the question. Moreover, the evidence does not establish that as of the end of the taxable year ended June 30, 1963, there was a definite plan to purchase any interest in that company. The evidence indicates that up to that time Klein had been engaged in nothing more than discussions of possibilities, and that not until after the end of the year was there even any investigation of the financial condition of the company. See *Wellman Operating Corporation, supra.* Furthermore, when Klein did conduct negotiations with regard to purchase terms in December 1963, he proposed that a part of the price be paid out of future earnings of the business of Artistic Greeting Card Company. For all that appears this may have been contemplated from the beginning. Under the circumstances we cannot conclude that as of the end of the taxable year ended June 30, 1963, the petitioner has shown that it had any reasonably anticipated business need to accumulate funds to purchase an interest in the Artistic Greeting Card Company. Moreover, even if it were concluded that at the end of such year there was a reasonably anticipated business

need for funds to purchase an interest in that company, this would not justify the accumulation of any earnings and profits of the taxable year ended June 30, 1963, since as pointed out *infra*, the petitioner had sufficient available earnings accumulated from prior years to more than provide the necessary funds.

At some undisclosed time during the taxable years in question the petitioner considered the purchase of a large block of stock in the Manz Corporation, which was in the lithography business. Substantially all the stock of that company was offered for sale for about $2,000,000 to $2,500,000. At some undisclosed time another party bought the company. Since this is all the evidence shown, obviously it is insufficient to show that as of the end of any of the taxable years here involved the petitioner had any reasonably anticipated need for funds in connection with the acquisition of an interest in such company.

At June 30, 1961, the petitioner had accumulated earnings and profits, exclusive of earnings and profits of that taxable year, of $4,772,080.74. At that time it also had liquid assets including cash of $1,948,241.20 and stocks, bonds, and other securities of $682,356.75. Thus, at the end of the taxable year ended June 30, 1961, the petitioner had accumulated earnings and profits of prior years, in liquid form, far in excess of any proven reasonable needs of the business for that year, including any reasonably anticipated future needs. The only reasonable needs including anticipated needs, shown as of that time amounted to $782,000. The same is true with respect to the taxable years ended June 30, 1962 and June 30, 1963. As of June 30, 1962, the petitioner had accumulated earnings and profits, exclusive of earnings and profits of the taxable year ended June 30, 1962, of $4,919,779.18 and had cash and securities of $2,866,197.91, whereas the proven needs

amounted to $782,000. As of June 30, 1963, petitioner had accumulated earnings and profits, exclusive of earnings and profits of the taxable year ended June 30, 1963, of $5,045,466.44 and had cash and securities of $2,667,923.39, whereas it did not prove any reasonable needs as of that time.

The petitioner paid dividends of only $15,400 for each of the taxable years in question, whereas its retained earnings and profits for those three years amounted to $147,698.44, $125,687.26, and $85,568.98, respectively.

In view of the foregoing, we have concluded and have found as a fact that during the years in question petitioner permitted its earnings and profits to accumulate beyond the reasonable needs of its business. Section 533(a) provides that such fact shall be determinative of the purpose to avoid the income tax with respect to the shareholders unless the corporation by the preponderance of the evidence shall prove to the contrary.[11] The petitioner has introduced no evidence to rebut the presumption contained in section 533(a). Accordingly, we hold that petitioner has not shown that it was not availed of during the years in question for the purpose of avoiding the income tax with respect to its shareholder by permitting its earnings and profits to accumulate instead of being divided or distributed.

The petitioner further contends that the accumulated taxable income for each year, which is the basis upon

11. In *United States* v. *The Donruss Company*, 393 U.S. 297 (January 13, 1967) [23 AFTR 2d ....., para. 69-418], the Supreme Court held that in order to rebut the presumption contained in section 533(a) the taxpayer must establish that tax avoidance with respect to its shareholders was not "one of the purposes" for the accumulation of earnings beyond the reasonable needs of the business and that it is not sufficient to prove that tax avoidance was not the "dominant, controlling, or impelling" reason for the accumulation.

which the tax is computed (section 531), should be reduced by the amounts it expended to pay premiums on insurance on the lives of Klein and other key employees.

Section 535(a) of the Code defines "accumulated taxable income" as the taxable income, with certain adjustments (none of which would include life insurance premiums) minus the dividends paid deduction and the accumulated earnings credit. The petitioner states that it was the owner of the policies and concedes that, in view of the provisions of section 264(a) (1) of the Code,[12] such premiums are not deductible in computing taxable income, yet it has not pointed to any other provision of the law which would permit the reduction of accumulated taxable income. It does not contend that the payment of the premiums constituted dividends for purposes of the dividends paid deduction, nor does it contend that they should be included in the calculation of the accumulated earnings credit provided for by section 535(c). It merely states on brief that "premium on the life insurance was proper; was paid out; was no longer available for distribution; did not constitute an accumulation; and should have been considered in determining the remaining earnings during the taxable years available for distribution."

Since Congress has specifically provided for the deductions and adjustments to be taken into account in computing accumulated taxable income, and since we cannot find that these insurance premiums fall within any of the prescribed deductions or adjustments, we conclude that there is no merit in this contention of the petitioner.

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12. Section 264(a)(1) of the Code provides:

(a) General Rule.—No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

In view of the foregoing, we hold that for the taxable years in question the petitioner is subject to the accumulated earnings tax imposed by section 531 of the Code, and the respondent's determination is approved.

Decision will be entered for the respondent.

DECISION

(Filed September 18, 1969)

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed August 11, 1969, it is

ORDERED and DECIDED: That there are deficiencies in income tax for the taxable years ended June 30, 1961, 1962 and 1963 in the respective amounts of $10,734.55, $12,132.17, and $6,172.21.

Entered: SEP 18, 1969

(Signed) Craig S. Atkins
Judge

(Seal)

In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1628

NOVELART MANUFACTURING COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A4-A39) is reported at 52 T.C. 794. The opinion of the court of appeals (Pet. App. A1-A3) is reported at 434 F. 2d 1011.

JURISDICTION

The judgment of the court of appeals was entered on November 27, 1970. A petition for rehearing was denied on January 25, 1971. The petition for a writ of certiorari was filed on April 24, 1971. The

jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether, in the circumstances, both courts below correctly held that petitioner was liable for the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code.

2. Whether, in computing petitioner's accumulated taxable income subject to the Section 531 tax, both courts below correctly denied petitioner a deduction for premiums paid for key-man life insurance.

STATUTES AND REGULATIONS INVOLVED

Certain of the pertinent provisions of the Internal Revenue Code of 1954 are set forth in the petition (pp. 4-9). Additional statutory provisions and the pertinent provisions of the Treasury Regulations are set forth in the Appendix, *infra*, pp. 9-10.

STATEMENT

During the taxable years here in issue, those ended June 30, 1961, 1962 and 1963, petitioner had substantial investments in securities and real property. In its income tax returns for the years, it described the principal activity in which it was engaged as "Investments and Lessor of buildings." Its 80 percent-owned subsidiary was engaged in a lithographing, printing and binding business, in connection with which petitioner conducted some related research and development activities. Petitioner's sole stockholder was Charles H. Klein, to whom it paid annually

$42,000 in salary and $15,400 in dividends. (Pet. App. A5, A7, A19.)

At the beginning of fiscal 1961, petitioner's accumulated earnings and profits amounted to more than $4.7 million. Accumulated earnings and profits increased during the three years involved by $147,000, $125,000 and $85,000, respectively, and, at the end of fiscal 1963, exceeded $5.1 million. As of the beginning and end of each of the years, petitioner's liquid assets (consisting of cash, government obligations, stocks, bonds and other securities) were never less than $2.6 million, and its liabilities were never as much as $483,000. (Pet. App. A17-A18.)

The Commissioner of Internal Revenue asserted accumulated earnings tax deficiencies against petitioner on the ground that it had permitted its earnings and profits to accumulate beyond the reasonable needs of its business, for the purpose of avoiding the income tax with respect to its sole shareholder.[1] At trial in the Tax Court, petitioner contended that its substantial accumulations were needed to meet a variety of reasonably anticipated business needs. See Section 537, Appendix, *infra*, p. 9. After a careful review

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[1] The tax applies where the accumulation is for this purpose. Section 532(a), Appendix, *infra*, p. 9. An unreasonable accumulation is determinative of the proscribed purpose, "unless the corporation by the preponderance of the evidence shall prove to the contrary." Section 533(a), Appendix, *infra*, p. 9. A purpose to avoid shareholder income tax need be only one of the purposes of the accumulation in order for the tax to apply. *United States* v. *Donruss Co.*, 393 U.S. 297. Petitioner has not attempted to show that, if its accumulations were unreasonable, they were not for the purpose of avoiding shareholder income tax.

of the evidence (Pet. App. A29-A36), the Tax Court found that $782,000 was sufficient to meet such needs,[2] an amount substantially less than both petitioner's accumulated earnings and profits and its liquid assets at the beginning of fiscal 1961 and throughout the years in issue. It held that petitioner had unreasonably accumulated its earnings for each such year, had failed to show that this was not for the purpose of tax avoidance, and, therefore, was liable for the accumulated earnings tax imposed by Section 531 of the Internal Revenue Code. (Pet. App. A36-A37.)

Petitioner also contended that, in computing its accumulated taxable income subject to the Section 531 tax, it was entitled to deduct the premiums it paid for key-man life insurance. The Tax Court rejected this contention. It noted that such premiums are not deductible in computing taxable income pursuant to Section 264(a)(1). Since Section 535 (Pet. 6-9), to the extent here relevant, defines accumulated taxable income as taxable income with specified adjustments, and since key-man life insurance premiums are not among the adjustments specified, the court reasoned that there was no basis for allowing petitioner a deduction. (Pet. App. A38.)

On appeal, the Sixth Circuit held that the Tax Court's findings with regard to the unreasonableness of petitioner's accumulations were supported by sub-

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[2] In determining petitioner's reasonably anticipated business needs, the Tax Court included the business needs of petitioner's 80 percent-owned subsidiary as required by Treas. Reg. 1.537-3(b) (Pet. App. A27 n. 8).

stantial evidence. It also affirmed the lower court's holding on the computation of accumulated taxable income. Finally, it rejected petitioner's claim, made for the first time on appeal, that the tax imposed herein is unconstitutional. (Pet. App. A1-A3.)

ARGUMENT

The decision below is correct. There is no conflict or other reason for further review.

1. The principal question here is whether petitioner's accumulated earnings exceeded the reasonable needs of its business. Both courts below having concluded that petitioner's accumulations were unreasonably large, there is no basis for review by this Court of this essentially factual question. See *Comstock* v. *Group of Investors*, 335 U.S. 211, 214.

2. Petitioner's principal arguments center on the proposition that the reasonableness of an accumulation should be determined without regard to earnings accumulated as of the beginning of the taxable year. Thus, for example, petitioner contends that the courts below erred in holding, and finding relevant the fact, that petitioner's accumulation at the beginning of each taxable year exceeded its reasonably anticipated business needs for that year. The effect of doing so, petitioner maintains (Pet. 26-27), is to tax its prior accumulations retroactively, even though the statute of limitations for the prior years had run. There is no merit to these arguments.

In determining whether a corporation's earnings and profits for a taxable year exceed the reasonable needs of the business, "the amount of the earnings

and profits accumulated in prior years shall, of course, be taken into account." S.Rep. No. 1622, 83d Cong., 2d Sess., p. 317. If accumulated earnings of prior years are sufficient for the reasonable needs of the business, then any accumulation of earnings for the taxable year is unreasonable. Treasury Regulations on Income Tax (1954 Code), Section 1.535-3 (b)(1), Appendix, *infra*, p. 10. This is so at least to the extent that accumulated earnings are reflected in liquid assets. *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F. 2d 495, 500-501 (C.A. 4), certiorari denied, 362 U.S. 976.

The effect of taking prior years' accumulations into account is not to tax those accumulations as petitioner claims. This is made clear by the instant case itself. Although petitioner's accumulated earnings and liquid assets at the beginning of fiscal 1961, $4.7 million and $3 million, respectively, each exceeded its reasonable business needs for that year of $782,000, no tax was imposed on either excess amount. As petitioner's own table shows (Pet. 15), the tax was levied only on its additional accumulation for that fiscal year, computed in accordance with the provisions of Section 535. The same holds true for the later taxable years.

3. Petitioner's remaining contentions do not merit extended discussion. Its constitutional argument (Pet. 32-38) is inconsistent with this Court's decision more than 30 years ago in *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46. Its argument regarding the treatment of key-man insurance premiums (Pet. 27-32) was fully answered in the opinions of the Tax Court (Pet. App. A37-A38) and the court of appeals (Pet.

App. A3) on which we here rely. As for its claim that interest does not begin to run on an accumulated earnings tax deficiency until after notice and demand therefor (Pet. 25-26), this was not raised in either court below and, accordingly, is not properly before this Court. At all events, the claim is premature. No interest has yet been assessed, nor was the interest question one that could have been resolved by the Tax Court in the proceedings below. The date from which interest is to run is "not within the issues before the Tax Court since such interest can only be determined after a final judgment in the deficiency proceeding * * *." *Transport Mfg. & Equipment Co.* v. *Commissioner*, 434 F.2d 373, 382 (C.A. 8). No such judgment has yet been entered here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1971.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * * *

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For the purposes of this part, the term "reasonable needs of the business" includes the reasonably anticipated needs of the business.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

SEC. 1.535-3 *Accumulated earnings credit.*

* * * *

(b) *Corporation which is not a mere holding or investment company*—(1) General rule. * * *

(ii) In determining whether any amount of the earnings and profits of the taxable year has been retained for the reasonable needs of the business, the accumulated earnings and profits of prior years will be taken into consideration. Thus, for example, if such accumulated earnings and profits of prior years are sufficient for the reasonable needs of the business, then any earnings and profits of the current taxable year which are retained will not be considered to be retained for the reasonable needs of the business. See section 537 and §§ 1.537-1 and 1.537-2.

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